INVESTING CONSUMER PSYCHOLOGY

Here’s the Root of Our Financial Problems

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Why people screw up.

Jeffrey Coolidge—Getty Images

Massimo Piattelli-Palmarini, an Italian cognitive psychologist, was once asked a simple question: Why do people err?

He responded: “Inattention, distraction, lack of interest, poor preparation, genuine stupidity, timidity, braggadocio, emotional imbalance, ideological, racial, social or chauvinistic prejudices, as well as aggressive or prevaricatory instincts.”

Just to name a few.

I’d add a couple to the list relevant to investors.

No room for error

In 2008 a money market fund called Reserve Primary owned some Lehman Brothers bonds. Then Lehman Brothers went bankrupt, causing the per-share price of the Reserve Primary fund to fall from $1.00 to $0.985.

By any sensible measure this was not a big deal. Investors lost 1.5% of their money. It happens. It was less than they gave up to inflation in the previous 3 months.

But the money market funds spent years convincing investors they could enjoy high returns with no chance of loss. So the tiny dip in Reserve Primary led to a run and near collapse of the entire money market industry. It was one of the lead causes of the 2008 financial crisis, and a reminder that a small loss mixed with unreasonable expectations is far worse than a huge loss with reasonable expectations.

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Unless someone with deep pockets has explicitly insured your outcome, you, your family, your friends, your advisors, your employers, and your politicians will screw up from time to time. It's usually not a big deal. But the trifecta of obliviousness, leverage, and unrealistic expectations can cause small mistakes to snowball into catastrophic losses. Look hard enough and you'll see that most long-term wealth isn't caused by prescience, but the opposite: room for error.

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Wrong about what it means to be wrong
Say it's 2006, and I predict the housing market is a bubble and its inevitable collapse will cause a huge recession and bear market.

Then those exact things happen.

Was I right?

Probably not.

A handful of investors predicted the financial crisis before 2008. They were called heroes and financial geniuses. But most of them were right for the wrong reason.

Most predicted surging interest rates and a collapsing dollar would cause the impending crisis. Instead, interest rates fell to negative levels and the dollar surged to the highest level in years.

Here's what Peter Schiff — one of the guys who predicted the crash but got the mechanics backwards — said in Dec. 2006: "Interest rates are one of the problems for the housing market, and they're going a lot higher." The 10-year Treasury bond yielded 4.7% that day. Six years later it was at 1.5%, an all-time low.

"Most people, whether bull or bear, when they are right, are right for the wrong reason," blogger Jesse Livermore wrote.

People are wrong so often that being right for the wrong reason feels good enough to call it a win. The irony is that being right for the wrong reason is worse than just being wrong, because it falsely inflates your confidence about future predictions.

Constantly smiling
Psychologists Lauren Alloy and Lyn Abramson have shown that those with mild depression have a more realistic assessment of the future than most people. They're better at predicting their longevity, odds of unemployment, odds of divorce, and the likelihood of illness.

In her book *The Optimism Bias*, Tali Sharot wrote:

> Optimism protects us from accurately perceiving the pain and difficulties the future undoubtedly holds, and it may defend us from viewing our options in life as somewhat limited. As a result, stress and anxiety are reduced, physical and mental health are improved, and the motivation to act and be productive is enhanced.

Relentless optimism, in other words, is a great way to live a happy life. But it's a form of ignorance, blinding us to the realty that the history of almost everything is filled with failure, disaster, ruin and scandal.

Optimism wins in the long run, but only if you can ride out inevitable bouts of pain and bad luck. Too much optimism prevents you from doing that. Embracing the reality of

how the world works requires you to be a little bit depressed.

Poor imagination

When Warren Buffett started looking for a successor he said he needed "someone genetically programmed to recognize and avoid serious risks, including those never before encountered."

Preparing for risks "never before encountered" requires imagination. Or at least it requires the ability to think beyond spreadsheets and historical data.

Ten years ago, Lehman Brothers going bankrupt, the federal government shutting down, bond yields going negative, and printing $3 trillion of money without sparking inflation could hardly be imagined. But they all happened.

In his book *Antifragile*, Nassim Taleb wrote:

> "Risk management professionals look in the past for information on the so-called worst-case scenario and use it to estimate future risks — this method is called "stress testing."
>
> They take the worst historical recession, the worst war, the worst historical move in interest rates, or the worst point in unemployment as an exact estimate for the worst future outcome.
>
> But they never notice the following inconsistency: this so-called worst-case event, when it happened, exceeded the worst case at the time.
>
> I have called this mental defect the Lucretius problem, after the Latin poetic philosopher who wrote that the fool believes that the tallest mountain in the world will be equal to the tallest one he has observed. We consider the biggest object of any kind that we have seen in our lives or hear about as the largest item that can possibly exist.

People say "I'm saving for a house" or "I'm saving for vacation," but "I'm saving for an unknown future event or opportunity that I can't comprehend today" makes you sound paranoid. Given enough time, though, it's one that nearly all of us will benefit from.

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