The Rational Reminder Podcast EP.38

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore.

Today, we really talked about the name and introduction of the podcast. We talked about rational decision making and feelings and financial decisions. We've talked a lot about feelings, not our own feelings.

[0:00:31.3] Cameron Passmore: The name of the podcast was deliberate, it was to be that rational reminder of what you should know when you're making decisions, had so many cases lately where people are making decision explicitly based on how they feel.

[0:00:42.5] BF: Yeah. Today, we try to cover off — just the role of feelings and decision making and financial decision-making, we kind of touched on like, what is a good decision? Because it's not necessarily going to be the rational decision.

[0:00:56.2] CP Nor the best decision. But probably isn't going to be rational. Most people don't make rational decisions. Most people make emotional decisions, then justify it with rational thinking after the fact.

[0:01:07.9] BF: Right, which by definition is flawed rationale. Anyway, we talked about that, we talked about couple of podcast housekeeping items and one story form out on the web. Anyway, you had a good weekend? You were away?

[0:01:22.1] CP I was away for a few days, up to a resort near Whitney, Ontario, right in the edge of [inaudible] park, amazing, beautiful weather, beautiful country, went through a great hike in the park, never been there before.

[0:01:33.8] BF: I've never been either.

[0:01:34.2] CP It's stunning area and close to Ottawa. It's super fun. Then heading to Australia next week.

[0:01:43.2] BF: Pretty cool.

[0:01:43.7] CP Yeah, going to be at Dimensional Global Conference which first time I've been and I've been invited to participate in the panel on using social media in the client experience. We'll talk about your YouTube channel which has huge traction and our podcast which is growing every week, how to do it, how to implement it, what the results have been like.

[0:02:04.4] BF: Yeah, that just made me think of something that I wanted to say in the episode but forgot, so here we are. If you're listening to the podcast and you enjoy it, rating it on iTunes is great but if you share it with somebody that you think would find the information useful, that would be very much appreciated by us.

[0:02:21.8] CP We're not promoting this anywhere, this is solely an organic source of, hopefully, valuable information.

[0:02:28.7] BF: But the more people that listen, I finally get really interesting feedback and the larger we'd grow the audience, the better I imagine that will get.

[0:02:36.1] CP 100% agree.

[0:02:37.3] BF: All right.

[0:02:37.5] CP Here you go, have a listen.

[EPISODE]

[0:02:45.3] BF: Welcome to Episode 38 of the Rational Reminder Podcast. If you're new to the podcast, we know we've been getting a fair amount of new listeners. Cameron and I, the hosts here, we're portfolio managers at PWL Capital in Ottawa and we use it to podcast, talk about all kinds of personal finance related stuff but definitely a focus on I guess investing and portfolio management because that's kind of where our heads are most of the time but we do try to keep a pretty balanced range of topics.

[0:03:13.6] CP: And some stories from the front when we can share them.

[0:03:17.5] BF: Yup, we try to have it, we don't try, we have a guest every other episode, we alternate between us talking to each other and having a subject matter expert as a guest.

[0:03:28.0] CP: I think this tempo is working. I think it's a good mix of the two, perhaps we went a little heavy on the investing for a while but I think we have stuff we had to get covered off.

[0:03:35.8] BF: Yeah.

[0:03:36.2] CP: But now that we're in the tempo and the model portfolio has been built and some really good guests have been on and are lined up to come on.

[0:03:45.0] BF: Yeah, on today's episode, we want to talk about something that comes up for Cameron and I, I mean, every day, really. It's feelings. Which may sound kind of funny.

[0:03:56.5] CP: Especially if you know us.

[0:03:59.0] BF: Yeah, we're not going to talk about each other's feelings, we don't talk about that much but it comes up a lot and it's come up a lot lately. Very specifically that feelings are driving decisions.

[0:04:06.9] CP: Yeah, I mean, people say it all the time. "I feel like this is a good decision." Or, "I feel like we shouldn't do this or we should do that." And it's a really hard problem to tackle because we, in our role, like to try and help people make decisions that are rational or logical but if that doesn't feel like a good decision, it might end up being a bad decision, even if it is rational.

[0:04:31.1] BF: Because? Because if people – well, if you make a rational decision, you're not always going to get the expected outcome.

[0:04:36.7] CP: Yup.

[0:04:37.7] BF: If people feel bad about making a rational decision and then don't get the good outcome.

[0:04:42.8] CP: Then they just question their judgment again.

[0:04:44.6] BF: They question their judgment but they feel bad.

[0:04:48.1] CP: Often, feelings can really motivate people so if you feel something is better, that could really drive your motivation to execute on that plan of action.

[0:04:55.5] BF: Yup. We're going to talk about feelings but before we get there, before we get into it deep, we want to talk about a couple of other things, a couple of housekeeping items for the podcast, one story and then we'll get in to our main topic.

A few episodes ago, we talked about the safe savings rate which was – is really interesting research and we were pretty excited about it when we walked about it and we said that we were going to take some time and go and dig into it and see if it's something that we can actually implement and the answer to that question ended up being a pretty hard no.

[0:05:34.2] CP: Yeah, it's a tough nut to crack, just not enough data, right?

[0:05:38.0] BF: The problem is the data. I mean, the research is based on US stock data going back to 1871. The problem is, when we're talking about safe savings rate, we're talking about modeling a 30 year saving period or in the example that we were talking about in the podcast last time, a 30 year period of saving and then a 30 year period of spending. 60 years.

In reality, that probably isn't even long enough but for a 60 year period going back to 1871, we have two full sets of non-overlapping data. Two periods which isn't a lot.

[0:06:12.4] CP: Right.

[0:06:13.3] BF: You start going, what other data is out there? You start looking for global data which exists going back to 1900 but we've got the same problem. Just barely two none overlapping 60 year periods. Again, 60 years is probably isn't even long enough, for a real person.

[0:06:30.1] CP: Do you think it matters that the markets have changed over time very much, how much would that impact the data?

[0:06:34.6] BF: That's the problem, we don't know. This is the problem, safe savings rate takes, it is based on the assumption that stock returns will revert to the mean.

[0:06:43.7] CP: Correct.

[0:06:44.4] BF: If you save through a period of higher than — well, high returns, you should expect lower returns for your spending period which affects the amount that you should –

[0:06:56.4] CP: Had to stay less while the market is doing well and withdrawal rate on the back end had to be lower.

[0:07:02.9] BF: Right. The whole thing is decoupling how much you have in assets from how much you need to save but that's based on the assumption that if you have higher assets than you maybe would have expected to have, you should expect lower returns going forward.

[0:07:19.5] CP: But there's not enough data to suggest that there is an expected meaner version.

[0:07:24.4] BF: Well, the data that we have shows that that has happened but the problem is we only have two none overlapping periods. The solution to that when we're talking about financial planning research is always bootstrap. Instead of taking the time period that we have from real historical data,

you take all of the data for those time periods, take the monthly returns and you create your own set of data which you have control over the time period.

We could make as many 60 year periods as we want to do with bootstrap. Just taking each month from historical return and putting it back in the data set to recreate a 60 year period. The problem for safe savings rate with bootstrap is that you completely eliminate any trend.

[0:08:07.0] CP: Exactly.

[0:08:08.2] BF: Like that idea that if stock returns have been high, they're going to be lower, if they have been low, they're going to be high moving forward. That goes away completely with bootstrap for sure.

[0:08:17.7] CP: It makes it more normal.

[0:08:19.5] BF: Yeah, there's no serial correlation in the data. When you read the financial market research, especially from guys like Fama and French, they believe that there should not be any serial correlation modeled when you're looking at stark returns.

If you ask them, they would say that bootstrap is fine even though it destroys your own correlation but in any case, the only way we can get enough data to use something like safe savings rate is through bootstrap and bootstrap destroys the thing that makes safe savings rate work.

[0:08:51.2] CP: Right. What's the key takeaway then? Just to be aware of what your savings rate is? Which as we said on the podcast, many people don't even know that for themselves.

[0:08:59.2] BF: Yeah, I think in practice, we sort of do – it's pretty interesting actually, we kind of do take the safe savings rate type idea into account just based on the way that we do our expected returns for financial planning because we adjust our expected returns every six months and our expected return assumptions are affected by current price earnings.

If current price earnings are high, we lower our expected returns.

[0:09:24.9] CP: Yeah, it's not predictive, it's just adjusting the model to reflect what has happened.

[0:09:29.7] BF: Correct. In a way –

[0:09:32.1] CP: Which affects savings rate as you update the planner time.

[0:09:34.6] BF: Correct. Which is kind of similar I guess except not really. We're addressing it more frequently; safe savings rate would have you not adjust ever. Based on the few historical trends that we have to follow. Anyway, safe savings rate is hard to say. It's really a neat idea and behaviorally, I really liked it but in practice, when we started digging into how comfortable would we be basing actual financial decisions on it, not so much.

I had a quote from I think Eugene Fama, that kind of summarizes why but remember, this is all based on mean reversion for safe savings rate to work. Fama said, something along the lines of stock returns may be mean reverting but we don't know what the mean is and we don't know when the reversion will happen.

Even if they are mean reverting, even if we assume that they will go up if they've been low, stock returns, you don't know when they're going to go up and if it doesn't happen at the right time for your retirement, you're going to run out of money.

I guess that was a – we're pretty excited about this last time, this is like the academic —equivalent of a retraction.

[0:10:43.3] CP: That's good information for people to have, we thought it through. Let's talk about the ETF model portfolios. I know you had someone reach out to you wondering where they were online if they wanted to go build it on their own.

[0:10:53.7] BF: Yeah, we have the paper, I've reviewed the first draft and I had to make a couple of edits but I hoping it's out this week and that will be on the PWL Capital website and once it's up, we can also put it in the notes for this episode of the podcast and then the model portfolios.

Separate from the paper where we introduced the portfolios and then the PDF just like we have for the model portfolios on our PWL site, we're going to post rational reminder model portfolios on rational reminder.ca which is our website for the podcast so hopefully this week those will go up.

[0:11:27.3] CP: It's worth mentioning that these aren't portfolios that we use normally with our clients.

[0:11:32.6] BF: Yeah, I had that question from somebody. Yes, we are not implementing these at all whatsoever. This is our attempt to create something that a do it yourself investor who cannot access Dimensional Funds to allow them to build something that at least has factor exposure, that's all this is. We're not using these for clients.

If people want to use them to kind of implement the type of stuff that we talk about in the podcast and I think that's great but to be very clear, we're not changing what we do, we still believe that Dimensional is the best thing for our clients.

[0:12:06.9] CP: They could use it as their own benchmark too if they wanted to. But factor tilt portfolio returns made it look like.

[0:12:12.4] BF: Sure.

[0:12:13.3] CP: Did you see the article of Michael Batnick had up?

[0:12:15.9] BF: Yeah, it was hard to listen, it was everywhere.

[0:12:17.7] CP: Man, he gets a lot of activity on his post but he wrote *The Twenty Craziest Investing Facts Ever*.

[0:12:24.1] BF: You picked five of them that you liked the most?

[0:12:26.4] CP: Hopefully agree, I don't know if you went through the whole list or not but I thought they were pretty good.

[0:12:29.8] BF: Well, read them out, they are good.

[0:12:31.7] CP: Get this, the Dow index has spent more time 40% or more below the highs than within 2% of the highs. Absolutely staggering to me that it was that long below the highs over a long period of time.

[0:12:49.0] BF: That one surprised me actually.

[0:12:51.0] CP: US 1-month T-bills went 68 years with a negative real return.

[0:12:55.7] BF: Unreal.

[0:12:56.6] CP: That's when you knock off inflation. Gold and the Dow were both 800 level in 1980. Today, gold is $1300 an ounce and the Dow is near 26,000.

[0:13:07.9] BF: Wow.

[0:13:08.8] CP: If you had invested from 1960 to 1980, in those 20 years and had beaten the market by 5% each year, you would have less money than if you had invested 20 years again from 1980 to 2000 and had underperformed the market by 5% a year.

[0:13:26.4] BF: That one's wild.

[0:13:27.5] CP: That just blow you away, when you were born and when you started investing mattered more that how well you did relative to the market. Get this one, only 47% of stocks generated a lifetime return that match one-month T-Bills.

[0:13:43.0] BF: That one's good but there's an even crazier stat along those lines, it's that from 1926 through 2016 or 17, 4% of the stocks in the US were responsible for 100% the return in excessive T-bills.

That just speaks, I think Michael noted this in his post too, that just speaks to the distribution of stock returns and why it's so hard to beat the market because if you don't get those tiny few that drive most of the markets with performance, you're going to underperform.

[0:14:11.5] CP: Thea active managers say the opposite. If you avoid the ones that are really are so bad and just picked the ones that do well, you're going to blow your next out of the water.

[0:14:21.2] BF: If you could do that of course that's true, but you can't.

[0:14:23.8] CP: That's perpetual appeal of it.

[0:14:27.1] BF: I don't even know how you'd measure this but I'd like to see, those few stocks that drive most of the market's return, I'd love to see the media coverage or the sentiment around those stocks, those popular stocks, you know? Or those companies that people thought were going to drive the returns of the market.

[0:14:40.7] CP: Yeah, I remember seeing one article. I forget when but comparing Apple to Clorox. You know, at some period of time where Apple did so well and said yeah, had you bought Clorox, you would have done so much better. This is a while ago but there's always stats like that.

[0:14:55.8] BF: I've seen one like that, I think Netflix or Domino's beat Netflix over the last I don't know, five years or something.

[0:15:02.1] CP: We talk about your feelings now?

[0:15:06.1] BF: Yeah. Likely mentioned at the start, feelings come up for Cameron and I all the time, we spend a lot of time helping people make decisions but like we said earlier, decisions, they can't just be good – well I guess it raises the question of what is a good decision. Is it a good decision, a rational decision or is it a decision that feels good or is it some combination?

We're talking about people's money; this stuff is – we interviewed this one's not live yet but the neuro –

[0:15:37.3] CP: Dr. Moira Summers.

[0:15:38.1] BF: Moira Summers and she called money some fascinating term, it was like your financial life blood or what did she call it?

[0:15:46.5] CP: I forget the term also.

[0:15:48.2] BF: Yeah. The point is, money is obviously very important to people and it is, it's an expression of work that you've put in and decisions that you made. Anyway, when we're talking about decisions around money, people rightly do get very emotional. From our perspective, one of the challenges is t h at even though we may know what a rational decision is, or a logical decision is, that's not always going to be the right decision for someone to make.

[0:16:13.7] CP: Yeah, we're not talking about like active versus passive necessarily. Talking about feeling decisions, some of the examples we've heard just in the past few weeks. I feel that owning investment properties is real. Whereas owning stocks and bonds is not real, it's like this digital –

[0:16:28.5] BF: Therefore, not safe.

[0:16:32.4] CP: I can see how people might feel that way because you go touch your building but the data does not support that at all.

[0:16:38.3] BF: Well, it's not even about the data, it's just about property rights, right? Someone can take the title to your home just as easily as they can take your own security.

[0:16:46.6] CP: Drag away the building, right? Whereas I own the stock of pick whatever company want index, I don't really know what it is, I see the code and I see that none of my statements but –

[0:16:56.1] BF: You start talking about property rights, I mean, it gets pretty interesting pretty quickly because a piece of paper that says you own a home or a building or whatever. But that only exists because of the laws that we have in Canada or whatever country you're in –

[0:17:10.6] CP: What about the closet, the one we get all the time. "I think a dividend paying stocks are the most sensible investment. I like to get paid town the stock."

[0:17:17.3] BF: There's tons of data to refute that, we did a video on YouTube that's gotten a lot of views and some good discussion there but yeah, it's the same kind of thing.

[0:17:28.1] CP: And people will say yes but then you're right but I feel, it's better now. There is a better time for it.

[0:17:33.5] BF: Some people say that. The dividend one people are less inclined to say that it is not logical to invest in dividend stocks. But anyway, people will often say things like they feel like they're safer investing with one of the big banks.

But of course, everybody's covered by CIPF, everybody is Iroc regulated. So, it doesn't make a difference and the challenge with a lot of these is in the bank.

[0:17:55.4] CP: "What could go wrong with the bank? I feel this is the safest place to be."

[0:17:59.8] BF: But if you start picking through these things it's like, okay well, the banks they actually have a conflict of interest where their fiduciary duties to their shareholders first and then with investment properties it's like, "Okay, sure you feel good about it but you're massively under diversified and you can't possibly diversify enough to make a disappear liable investment."

But it is a challenge. We know what the data show but that's not always easy to communicate to humans. I think some of the main biases that we bump up against our confirmation bias.

[0:18:31.6] CP: But this is rampant anywhere in society now. There is so much information that people are quasi-addicted I think to information that validates their already held beliefs. This is not investing this is everywhere. I mean look at what happened in the US election, look at what happens in all kinds of different topics.

[0:18:50.1] BF: It plays into overconfidence bias but then we also got regret aversion, hindsight bias, familiarities, self-attribution, endowment and that is just a small list. But I think people end up making decisions based on how they feel and then looking for the rational to justify the decision that felt good.

And there is some research from the University of Chicago that you sent me on that, that people make snap decisions despite having tons of information and despite feeling like they would make a rational decision. People would make snap decisions and then it is really hard for them to change their minds once they have made that decision.

[0:19:25.7] CP: But this is a good trait to have as humans because we have to make so many decisions all day long. So, it is a very good trait to have just unfortunately, in many cases not a good trait to have because it is hard to understand the rationality then go and change your mind and most people don't want to change their mind.

It is a lot easier to keep your beliefs and keep reading information and we may be guilty of this as well, keep reading information. We do our best to try to consider active strategy and other different things that come along.

[0:19:52.9] BF: I don't know if we try to consider them. We read about them, I have ever considered one.

[0:19:57.4] CP: Well you haven't found one, it is compelling if you would. For sure you would.

[0:20:01.7] BF: Yeah, of course.

[0:20:02.7] CP: You have to but to be aware of that bias and most people aren't even aware of it because you have no time. Everyone is so busy now and we are all flooded with information on our smart phones.

This goes back to Danny Kahneman's book, *Thinking Fast and Slow*, the two systems. System one thinking which is the quick reactive two plus two, you know the number right away whereas you say

17x24, you have to pause and get close. But it makes your brain work too hard, if that is too hard why would you do that.

I think we face the same thing a lot when people come in here wondering about investment philosophies and that's why we decided a long time ago, we are not here to change people's minds about how they invest because you can't. Most people won't change their mind.

[0:20:44.7] BF: Yeah, so we both listened to Sam Harris did a live show with Danny Kahneman in New York and posted the audio as a podcast episode on his Making Sense Podcast. It was a good interview and their discussion.

So Kahneman, I don't think he needs introduction as Sam Harris said this in the podcast too, he is the only guest he's ever had that really doesn't need introduction but he is the father of modern decision-making thinking in our understanding of how humans make decisions.

[0:21:13.9] CP: Brilliant. It was a brilliant interview.

[0:21:15.6] BF: He had some really interesting – and I love the way Sam Harris asks questions. He doesn't say, "Tell me about this." He says, "How do you think about this?" not asking for fact. He's like, "How do you think about this topic?"

I thought that was great. Anyway, one of the things Kahneman said that I really liked was, I am just paraphrasing. I was taking notes while I was going for a walk, "The correlation between confidence and accuracy is not high. Intuition is not always a good thing."

And that is so relevant when we are talking about financial decisions and investing in general because people have – some things we're just talking about, people intuitively believe that dividend paying stocks are better investments. They might have that intuition and they make real decisions based on that intuition but the problem with intuition is that it is not always right. In fact, in a lot of cases it is wrong.

[0:22:07.6] CP: And the markets can't go up forever. Well we got 10 years now, there must be a correction incoming.

[0:22:11.6] BF: Yeah, all that same kind of thinking.

[0:22:13.9] CP: Yeah at least also when you go to choose an investment, right? You could see people wanting to buy an active mutual fund. It must make sense that you're smart, you have a CFA, you do research all day, you must be able to beat the market that's why you do what you do isn't it? So why can't you go find me people like that?

[0:22:29.6] BF: Yeah and that plays into one of the – Kahneman actually said this is his favorite bias when Sam Harris asked him what is his favorite one. He said, what do you call it, picking out the favorite of your ugly children or something.

Yeah but Kahneman said that his favorite one is non-regressive prediction which he described as drawing strong conclusions from weak evidence and so when we are talking about what you are just saying Cameron, if you find that actively managed fund or a hedge fund or a stock pick or whatever it is that has done really well, we're inclined to believe that they're skilled or that they are going to do well in the future.

Even though we got this tiny, tiny little piece of evidence that this one person has done well, meaning that they are potentially skilled and this huge weight of evidence showing that past performance doesn't indicate skill in most cases.

[0:23:20.6] CP: I can remember when that light went off from me back in '97-'98 having a debate with a colleague and I was the last man standing believing in active management in the office and that's when the light went off. He said, "But those returns could have been luck. You need to let go of your belief and just realize it could have been luck."

It all changed right then but I can remember hanging onto my feelings and I felt that this was a good manager. He was a good global manager, great reputation and sure enough, I had made the switch but soon after the returns imploded, they left Canada it was just a complete mess.

[0:23:57.5] BF: Wow, that non-regressive prediction also made me think of factor premiums like we talked about small cap in value a lot. Small cap in value have underperformed for say 10 years in the US anyway but again, that is a tiny little piece of evidence, 10 years relative to the massive weight of evidence that we have for all of history and all around the world.

[0:24:19.7] CP: And the returns are not unexpected. The experience we just have over the past decade is not unexpected. Unfortunately, you don't have that rational reminder that this is what can happen, you have no anchor into your feelings. All the value stocks are terrible not only value stocks, again going back to my great Canadian dividend paying stocks because they never let me down but you don't have the full view of all the data.

[0:24:43.0] BF: That's what Ken French, we saw did a talk a few years ago on [inaudible] Thinking which is probability updating but it is basically I guess the simplest way I can think to explain it is taking the new information and updating your existing beliefs with the new information but taking them into account the weight of the existing information and the weight of the new information.

So, if you have many, many years of data clearly show that stocks outperform bonds. And you've got 10 years restocks don't outperform bonds, the weight of the new evidence is very small and you are not going to change your expectation.

[0:25:21.4] CP: And probably even stronger if you live through it as an investor.

[0:25:24.4] BF: Well that's what –

[0:25:25.2] CP: And your own experience will drive it even more.

[0:25:27.8] BF: Yeah that is one of the articles that you sent me, talked about that too.

[0:25:32.7] CP: Well Danny Kahneman talked about that in doing interviews. He said people in face to face, when you experienced beating someone face to face, you put way more weight in that as part of your total decision to hire that person than is justified.

[0:25:47.3] BF: Right, yeah in your own experiences in general. They talked about scientists and how they will put more weight in their own results than they will on other people's results. You can think about that as investors too. If someone's had success picking stocks say for their whole life, they are never going to be an index investor.

[0:26:06.3] CP: I just had an interesting conversation on that. So someone I have been speaking to lately was in business and knew how they could control success in their business and the biggest learning he's had to change is to you can't control what the stocks will do but you can control your portfolio now.

So suppose you are trying to control and manage it to beat the market, the realization is now that no, I have to control the structure of my portfolio and let go of all that control in trying to beat the market.

[0:26:35.5] BF: That shows up a ton in the family office research that we pay attention to, they talk about that a lot. But of course, if someone has had success in business and they have built something that they are able to sell for a meaningful amount, of course they felt like they had control and they probably did have control.

And that they hope extends to investing but the reality is, it doesn't just because of the way public financial markets work.

[0:26:59.8] CP: But even controlling risk profiles, so even how you present risk to a client will drive their asset allocation.

[0:27:06.5] BF: But that applies to tons of different decisions.

[0:27:08.9] CP: But just thinking about that when you are with someone, when you talk about the chance of the downside lose for example in 2008 and the equity portfolio might have been down 35 to 45%.

If you present it that way as oppose to over long periods of time it outperform by whatever, one, two, three, 4% a year, if you focus on the downside, you will end up with a more conservative portfolio.

[0:27:27.7] BF: Yeah.

[0:27:28.1] CP: And I can tell you people are much more risk averse in early 2009 after the horrible market than they were beforehand.

[0:27:36.5] BF: Kahneman talked about that. He talked about the importance of framing and part of the discussion was if you were in a position to influence someone's decision, they were talking about physicians but I mean it applies to us as well.

Where we know based on data what the rational decision for someone to make is but we also know that they are going to make the decision that feels good. So Sam Harris was asking Kahneman, how do you help someone make a decision that's the right decision.

And Kahneman said, "Well it is all about the framing." Which is fascinating to think about because that puts us into position to frame decisions in a way that are going to influence the outcome which is kind of scary but one of my favorite examples I think in practice is if someone has a concentrated position in stock, maybe they inherited it, maybe it is a stock option type situation whatever it is but they've got this concentrated position one stock.

And there is a bias called the endowment bias where humans are – they will place more value on something that they already own. I mean regret aversion plays into this too, where you are concerned if you sell this thing that you currently own —

[0:28:44.3] CP: You have held out for so long.

[0:28:46.2] BF: If you sell it, you are going to regret –

[0:28:47.9] CP: Miss that gain.

[0:28:48.7] BF: Right. So I always try and flip the framing and ask the person that I am speaking with to flip around and think about say it is a $1 million in stock, what if that were cash?

And then think about all these financial goals that you have. You want to start the business in a couple of years. You want to retire at whatever age. Kids going to university, all these different priorities, if you have a million dollars in cash as oppose to in this stock, would you invest all of it in the stock?

And not once has someone answered the question as, "Yes, I would invest all of it in the stock," not once. It's just just flipping the framework.

[0:29:25.0] CP: Or we also framed it in terms of if you get another whatever, five, 10, $20 on that stock before you sell, what does it do to the success of your retirement plan? And the success, yeah it might be a few hundred thousand dollars of absolute capital if it does go up but your plan of success might go from 92 to 94%. It is not material in the scheme of economic freedom.

[0:29:48.6] BF: Right, that's framing it in terms of marginal utility. How much marginal utility do you get from an additional, say your stock doubles from a million to two million, if you are already able to retire with the one million, how much utility do you gain from having a double versus maybe if it goes to zero, you can no longer meet the retirement goal.

[0:30:06.3] CP: So you talked about you read a book called *Decisive*. I have not read it yet.

[0:30:10.5] BF: I read it a while ago.

[0:30:12.0] CP: I just thought some of the points you had were super interesting.

[0:30:14.8] BF: Yeah, so they break down the ways to get around the four things that make decision making really hard which are a lot of things we were talking about. The authors of this book suggest that you do four things. Widen your options, so that is thinking about other options that you haven't even thought of yet.

[0:30:34.4] CP: So how will that play in our world, someone coming in?

[0:30:37.5] BF: Geez, I don't know.

[0:30:38.3] CP: Like retire later, save more, is that the kind of thing?

[0:30:42.5] BF: Yeah, those are easy ones. Maybe if they think about selling their house, maybe adding in the option of what if you do reverse mortgage. What if you, instead of downsizing, sell to rent, I guess those.

[0:30:52.7] CP: Move to a cheaper location.

[0:30:54.6] BF: Yeah, those are just off the cuff examples but that applies to any situation, where if you are thinking about three different options, there may be a fourth one that you haven't thought of. Well there is probably almost always going to be some alternative.

The next one is to reality test your assumptions which means finding the data. If you are holding onto a stock because you feel like it is going to do really well, what if you go and look at the data on how individual stocks tend to do, which we talked about earlier and it is not very good, that may affect the decision.

[0:31:23.4] CP: Or even to understand what a reasonable expectation for return is. Some people said, "I want to make 10%." Based on what?

[0:31:30.4] BF: And the third one is to attain distance before deciding. Which basically means getting clear of your emotions which obviously as we've been talking about, they can play a really big role in decision making. Attaining distance may involve getting an outside view from a trusted source or something like that.

And then the last one is to prepare to be wrong. I love that one and I know we are not supposed to talk about Dimensional. But they always say that they're not supposed to. It is our podcast. I can talk whatever I want. Dimensional says that if small cap in value don't work out, the results will still going to be pretty good because they own the whole entire market.

[0:32:06.4] CP: I remember this debate I had with a reasonably high profile forecaster who is promoting a very constituted portfolio. We had a hedge fund and in gold with great passion, this has got to be gosh, 15 years ago and I said, "What if you are wrong?"

And he hadn't even considered that as an option. "What do you mean what if I'm wrong?" I said, "What if you are wrong?" And the hedge fund had – what was the percentage in one stock? It was in one crazy oil stock and then shortly after the manager quit the fund, the fund shut down. I don't know if people got their money back. I assume they did and gold has not been great but I am sure it has not been a good experience.

[0:32:48.9] BF: Right, yeah that is an interesting one. That plays into what we were talking about with the marginal utility on either side of the decision. If you keep your individual stock and it doubles, what do you gain but if it goes to zero, what do you lose in terms of lifestyle?

So prepare to be wrong, what happens if you don't get the outcome that you're expecting but you know what? That applies whether you are making a rational decision or not. Because even if you make a rational decision – that is one of the hardest things about rational decision making is that you might not get the outcome that you want it. There is a reasonable chance you won't get the expected outcome.

[0:33:26.8] CP: Right but we know people are wired to use less information than they think to make up their minds. That is the way we are. Once we made up our minds, we just go with it and then our world truthfully is good for the business because a lot of people come in and a lot of it is based on trust. They don't know how to do due diligence; most people aren't trained in this at all.

So, what do you expect people to do?

[0:33:50.0] BF: Right, I think more and more the people that we see are coming in after having listened to the podcast or after having watched the YouTube videos and so they have an idea regarding this type of due diligence they should be thinking about.

Anyway, so feelings are very important in decision making and particularly – or maybe not particularly but definitely important in investing and personal finance because every day there are decisions to be

made about all sorts of things and we would love to think that we could help everyone make a rational decision but the problem is that the rational decision is not always going to be the right one.

In a lot of cases, people are very comfortable making an irrational decision based on how they feel and there is nothing that we can say to fix that.

[0:34:38.5] CP: Correct.

[0:34:39.9] BF: Other than changing the framing maybe.

[0:34:40.9] CP: Perhaps.

[0:34:41.6] BF: All right, anything else?

[0:34:42.4] CP: No that was good, interesting.

[END]