The Psychology *of* Money

TIMELESS LESSONS ON WEALTH,
GREED, AND HAPPINESS

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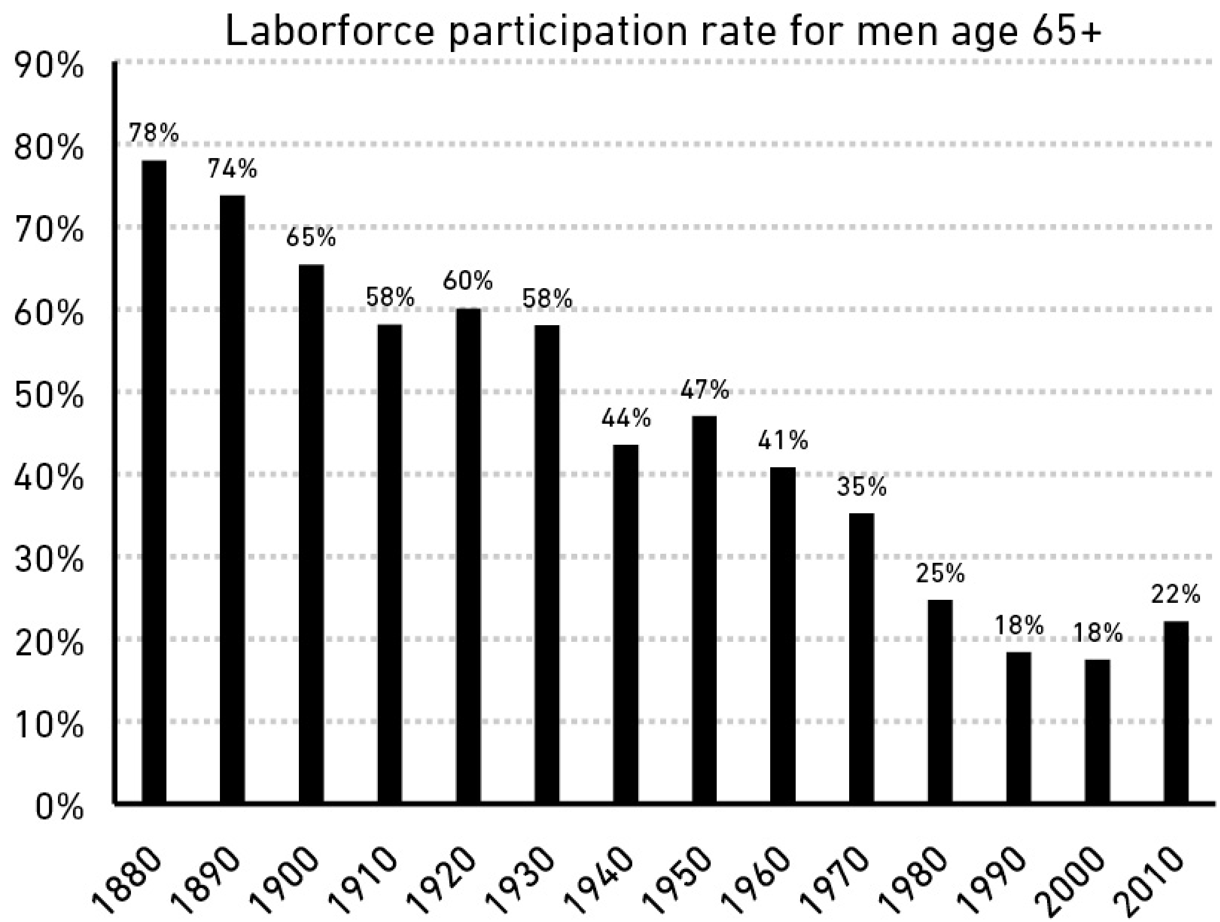
- Group 4: The Classified

For
My parents, who teach me.
Gretchen, who guides me.
Miles and Reese, who inspire me.

On we go.



Social Security aimed to change this. But its initial benefits were nothing close to a proper pension. When Ida May Fuller cashed the first Social Security check in 1940, it was for $22.54, or $416 adjusted for inflation. It was not until the 1980s that the average Social Security check for retirees exceeded $1,000 a month adjusted for inflation. More than a quarter of Americans over age 65 were classified by the Census Bureau as living in poverty until the late 1960s.

There is a widespread belief along the lines of, “everyone used to have a private pension.” But this is wildly exaggerated. The Employee Benefit Research Institute explains: “Only a quarter of those age 65 or older had pension income in 1975.” Among that lucky minority, only 15% of household income came from a pension.

The New York Times wrote in 1955 about the growing desire, but continued inability, to retire: “To rephrase an old saying: everyone talks innovation," to "You committed a crime?" Or how little would the story have to shift for the narrative to have turned from "Rockefeller was a genius, try to learn from his successes," to "Rockefeller was a criminal, try to learn from his business failures." Very little.

"What do I care about the law?" Vanderbilt once said. "Ain't I got the power?"

He did, and it worked. But it's easy to imagine those being the last words of a story with a very different outcome. The line between bold and reckless can be thin. When we don't give risk and luck their proper billing it's often invisible.

Benjamin Graham is known as one of the greatest investors of all time, the father of value investing and the early mentor of Warren Buffett. But the majority of Benjamin Graham's investing success was due to owning an enormous chunk of GEICO stock which, by his own admission, broke nearly every diversification rule that Graham himself laid out in his famous texts. Where does the thin line between bold and reckless fall here? I don't know. Graham wrote about his GEICO bonanza: "One lucky break, or one supremely shrewd decision—can we tell them apart?" Not easily.

We similarly think Mark Zuckerberg is a genius for turning down Yahoo!'s 2006 $1 billion offer to buy his company. He saw the future and stuck to his guns. But people criticize Yahoo! with as much passion for turning down its own big buyout offer from Microsoft—those fools should have cashed out while they could! What is the lesson for entrepreneurs here? I have no idea, because risk and luck are so hard to pin down.

There are so many examples of this.

Countless fortunes (and failures) owe their outcome to leverage.

The best (and worst) managers drive their employees as hard as they can.

"The customer is always right" and "customers don't know what they want" are both accepted business wisdom.

The line between "inspiringly bold" and "foolishly reckless" can be a millimeter thick and only visible with hindsight.

Risk and luck are doppelgangers.

This is not an easy problem to solve. The difficulty in identifying what is luck, what is skill, and what is risk is one of the biggest problems we face

4.

Confounding Compounding

$81.5 billion of Warren Buffett's $84.5 billion net worth came after his 65th birthday. Our minds are not built to handle such absurdities.

Even if “wealthy” is not a word you’d apply to yourself, the lessons from that observation apply to everyone, at all income levels.

Getting money is one thing.

Keeping it is another.

If I had to summarize money success in a single word it would be “survival.”

As we’ll see in chapter 6, 40% of companies successful enough to become publicly traded lost effectively all of their value over time. The Forbes 400 list of richest Americans has, on average, roughly 20% turnover per decade for causes that don’t have to do with death or transferring money to another family member.[17]

Capitalism is hard. But part of the reason this happens is because getting money and keeping money are two different skills.

Getting money requires taking risks, being optimistic, and putting yourself out there.

But keeping money requires the opposite of taking risk. It requires humility, and fear that what you’ve made can be taken away from you just as fast. It requires frugality and an acceptance that at least some of what you’ve made is attributable to luck, so past success can’t be relied upon to repeat indefinitely.

Michael Moritz, the billionaire head of Sequoia Capital, was asked by Charlie Rose why Sequoia was so successful. Moritz mentioned longevity, noting that some VC firms succeed for five or ten years, but Sequoia has prospered for four decades. Rose asked why that was:

> Moritz: I think we’ve always been afraid of going out of business.
>
> Rose: Really? So it’s fear? Only the paranoid survive?
>
> Moritz: There’s a lot of truth to that … We assume that tomorrow won’t be like yesterday. We can’t afford to rest on our laurels. We can’t be complacent. We can’t assume that yesterday’s success translates into tomorrow’s good fortune.

Here again, survival.

well, and one or two to be bonanzas that drive 100% of the fund's returns. Investment firm Correlation Ventures once crunched the numbers.[20] Out of more than 21,000 venture financings from 2004 to 2014:

65% lost money.

Two and a half percent of investments made 10x–20x.

One percent made more than a 20x return.

Half a percent—about 100 companies out of 21,000—earned 50x or more. That's where the majority of the industry's returns come from.

This, you might think, is what makes venture capital so risky. And everyone investing in VC knows it's risky. Most startups fail and the world is only kind enough to allow a few mega successes.

If you want safer, predictable, and more stable returns, you invest in large public companies.

Or so you might think.

Remember, tails drive *everything*.

The distribution of success among large public stocks over time is not much different than it is in venture capital.

Most public companies are duds, a few do well, and a handful become extraordinary winners that account for the majority of the stock market's returns.

J.P. Morgan Asset Management once published the distribution of returns for the Russell 3000 Index—a big, broad, collection of public companies—since 1980.[21]

Forty percent of all Russell 3000 stock components lost at least 70% of their value and never recovered over this period.

Effectively all of the index's overall returns came from 7% of component companies that outperformed by at least two standard deviations.

That's the kind of thing you'd expect from venture capital. But it's what happened inside a boring, diversified index.

This thumping of most public companies spares no industry. More than half of all public technology and telecom companies lose most of their value and never recover. Even among public utilities the failure rate is more than 1 in 10:

There is a name for this feeling. Psychologists call it reactance. Jonah Berger, a marketing professor at the University of Pennsylvania, summed it up well:

> People like to feel like they're in control—in the drivers' seat. When we try to get them to do something, they feel disempowered. Rather than feeling like they made the choice, they feel like we made it for them. So they say no or do something else, even when they might have originally been happy to go along.[25]

When you accept how true that statement is, you realize that aligning money towards a life that lets you do what you want, when you want, with who you want, where you want, for as long as you want, has incredible return.

Derek Sivers, a successful entrepreneur, once wrote about a friend who asked him to tell the story about how he got rich:

> I had a day job in midtown Manhattan paying $20K per year—about minimum wage ... I never ate out, and never took a taxi. My cost of living was about $1000/month, and I was earning $1800/month. I did this for two years, and saved up $12,000. I was 22 years old.
>
> Once I had $12,000 I could quit my job and become a full-time musician. I knew I could get a few gigs per month to pay my cost of living. So I was free. I quit my job a month later, and never had a job again.
>
> When I finished telling my friend this story, he asked for more. I said no, that was it. He said, "No, what about when you sold your company?"
>
> I said no, that didn't make a big difference in my life. That was just more money in the bank. The difference happened when I was 22.[26]

The United States is the richest nation in the history of the world. But there is little evidence that its citizens are, on average, happier today than they were in the 1950s, when wealth and income were much lower—even at the median level and adjusted for inflation. A 2019 Gallup poll of 150,000 people in 140 countries found that about 45% of Americans said they felt "a lot of worry" the previous day.[27] The global average was 39%. Fifty-five percent of Americans said they felt "a lot of stress" the previous day. For the rest of the world, 35% said the same.

> calories as they had just burned off … the fact is, you can quickly undo a lot of exercise by eating a lot of food, and most of us do.

Exercise is like being rich. You think, “I did the work and I now deserve to treat myself to a big meal.” Wealth is turning down that treat meal and actually burning net calories. It’s hard, and requires self-control. But it creates a gap between what you could do and what you choose to do that accrues to you over time.

The problem for many of us is that it is easy to find rich role models. It’s harder to find wealthy ones because by definition their success is more hidden.

There are, of course, wealthy people who also spend a lot of money on stuff. But even in those cases what we see is their richness, not their wealth. We see the cars they chose to buy and perhaps the school they choose to send their kids to. We don’t see the savings, retirement accounts, or investment portfolios. We see the homes they bought, not the homes they could have bought had they stretched themselves thin.

The danger here is that I think most people, deep down, want to be wealthy. They want freedom and flexibility, which is what financial assets not yet spent can give you. But it is so ingrained in us that to have money is to spend money that we don’t get to see the restraint it takes to actually be wealthy. And since we can’t see it, it’s hard to learn about it.

People are good at learning by imitation. But the hidden nature of wealth makes it hard to imitate others and learn from their ways. After he died, Ronald Read became many people’s financial role model. He was lionized in the media and cherished on social media. But he was nobody’s financial role model while he was living because every penny of his wealth was hidden, even to those who knew him.

Imagine how hard it would be to learn how to write if you couldn’t read the works of great authors. Who would be your inspiration? Who would you admire? Whose nuanced tricks and tips would you follow? It would make something that is already hard even harder. It’s difficult to learn from what you can’t see. Which helps explain why it’s so hard for many to build wealth.

11.

Reasonable > Rational

Aiming to be mostly reasonable works better than trying to be coldly rational.

Fifteen billion people were born in the 19th and 20th centuries. But try to imagine how different the global economy—and the whole world—would be today if just seven of them never existed:

- Adolf Hitler
- Joseph Stalin
- Mao Zedong
- Gavrilo Princip
- Thomas Edison
- Bill Gates
- Martin Luther King

I'm not even sure that's the most meaningful list. But almost everything about the world today—from borders to technology to social norms—would be different if these seven people hadn't left their mark. Another way to put this is that 0.00000000004% of people were responsible for perhaps the majority of the world's direction over the last century.

The same goes for projects, innovations, and events. Imagine the last century without:

- The Great Depression
- World War II
- The Manhattan Project
- Vaccines
- Antibiotics
- ARPANET
- September 11th
- The fall of the Soviet Union

How many projects and events occurred in the 20th century? Billions, trillions—who knows. But those eight alone impacted the world orders upon orders of magnitude more than others.

Kevin Lewis, a successful card counter portrayed in the book *Bringing Down the House*, wrote more about this philosophy:

> Although card counting is statistically proven to work, it does not guarantee you will win every hand—let alone every trip you make to the casino. We must make sure that we have enough money to withstand any swings of bad luck.
>
> Let's assume you have roughly a 2 percent edge over the casino. That still means the casino will win 49 percent of the time. Therefore, you need to have enough money to withstand any variant swings against you. A rule of thumb is that you should have at least a hundred basic units. Assuming you start with ten thousand dollars, you could comfortably play a hundred-dollar unit.

History is littered with good ideas taken too far, which are indistinguishable from bad ideas. The wisdom in having room for error is acknowledging that uncertainty, randomness, and chance—"unknowns"—are an ever-present part of life. The only way to deal with them is by increasing the gap between what you think will happen and what *can* happen while still leaving you capable of fighting another day.

Benjamin Graham is known for his concept of margin of safety. He wrote about it extensively and in mathematical detail. But my favorite summary of the theory came when he mentioned in an interview that "the purpose of the margin of safety is to render the forecast unnecessary."

It's hard to overstate how much power lies in that simple statement.

Margin of safety—you can also call it room for error or redundancy—is the only effective way to safely navigate a world that is governed by odds, not certainties. And almost everything related to money exists in that kind of world.

Forecasting with precision is hard. This is obvious to the card counter, because no one could possibly know where a particular card lies in a shuffled deck. It's less obvious to someone asking, "What will the average annual return of the stock market be over the next 10 years?" or "On what date will I be able to retire?" But they are fundamentally the same. The best we can do is think about odds.

“All of us,” he said, “are walking around with an illusion—an illusion that history, our personal history, has just come to an end, that we have just recently become the people that we were always meant to be and will be for the rest of our lives.” We tend to never learn this lesson. Gilbert’s research shows people from age 18 to 68 underestimate how much they will change in the future.

You can see how this can impact a long-term financial plan. Charlie Munger says the first rule of compounding is to *never interrupt it unnecessarily*. But how do you not interrupt a money plan—careers, investments, spending, budgeting, whatever—when what you want out of life changes? It’s hard. Part of the reason people like Ronald Read—the wealthy janitor we met earlier in the book—and Warren Buffett become so successful is because they kept doing the same thing for decades on end, letting compounding run wild. But many of us evolve so much over a lifetime that we don’t want to keep doing the same thing for decades on end. Or anything close to it. So rather than one 80-something-year lifespan, our money has perhaps four distinct 20-year blocks.

I know young people who purposefully live austere lives with little income, and they’re perfectly happy with it. Then there are those who work their tails off to pay for a life of luxury, and they’re perfectly happy with that. Both have risks—the former risks being unprepared to raise a family or fund retirement, the latter risks regret that you spent your youthful and healthy years in a cubicle.

There is no easy solution to this problem. Tell a five-year-old boy he should be a lawyer instead of a tractor driver and he will disagree with every cell in his body.

But there are two things to keep in mind when making what you think are long-term decisions.

We should avoid the extreme ends of financial planning. Assuming you’ll be happy with a very low income, or choosing to work endless hours in pursuit of a high one, increases the odds that you’ll one day find yourself at a point of regret. The fuel of the End of History Illusion is that people adapt to most circumstances, so the benefits of an extreme plan—the simplicity of having hardly anything, or the thrill of having almost

16.

You & Me

Beware taking financial cues from people playing a different game than you are.

Pessimism just sounds smarter and more plausible than optimism.

Tell someone that everything will be great and they're likely to either shrug you off or offer a skeptical eye. Tell someone they're in danger and you have their undivided attention.

If a smart person tells me they have a stock pick that's going to rise 10-fold in the next year, I will immediately write them off as full of nonsense.

If someone who's full of nonsense tells me that a stock I own is about to collapse because it's an accounting fraud, I will clear my calendar and listen to their every word.

Say we'll have a big recession and newspapers will call you. Say we're headed for average growth and no one particularly cares. Say we're nearing the next Great Depression and you'll get on TV. But mention that good times are ahead, or markets have room to run, or that a company has huge potential, and a common reaction from commentators and spectators alike is that you are either a salesman or comically aloof of risks.

The investing newsletter industry has known this for years, and is now populated by prophets of doom despite operating in an environment where the stock market has gone up 17,000-fold in the last century (including dividends).

This is true beyond finance. Matt Ridley wrote in his book *The Rational Optimist*:

> A constant drumbeat of pessimism usually drowns out any triumphalist song ... If you say the world has been getting better you may get away with being called naïve and insensitive. If you say the world is going to go on getting better, you are considered embarrassingly mad. If, on the other hand, you say catastrophe is imminent, you may expect a McArthur genius award or even the Nobel Peace Prize. In my own adult lifetime ... the fashionable reasons for pessimism changed, but the pessimism was constant.

"Every group of people I ask thinks the world is more frightening, more violent, and more hopeless—in short, more dramatic—than it really is," Hans Rosling wrote in his book *Factfulness*.

When you realize how much progress humans can make during a lifetime in everything from economic growth to medical breakthroughs to stock market gains to social equality, you would think optimism would gain more attention than pessimism. And yet.

He’s in disbelief when he learns the stock market is worth half of what it was two years before.

He can’t believe that people’s forecast of their economic potential has plunged.

“I don’t get it,” he says. “I’ve seen the cities. I’ve looked at the factories. You guys have the same knowledge, the same tools, the same ideas. Nothing has changed! Why are you poorer? Why are you more pessimistic?”

There was one change the alien couldn’t see between 2007 and 2009: The stories we told ourselves about the economy.

In 2007, we told a story about the stability of housing prices, the prudence of bankers, and the ability of financial markets to accurately price risk.

In 2009 we stopped believing that story.

That’s the only thing that changed. But it made all the difference in the world.

Once the narrative that home prices will keep rising broke, mortgage defaults rose, then banks lost money, then they reduced lending to other businesses, which led to layoffs, which led to less spending, which led to more layoffs, and on and on.

Other than clinging to a new narrative, we had an identical—if not greater—capacity for wealth and growth in 2009 as we did in 2007. Yet the economy suffered its worst hit in 80 years.

This is different from, say, Germany in 1945, whose manufacturing base had been obliterated. Or Japan in the 2000s, whose working-age population was shrinking. That’s *tangible* economic damage. In 2009 we inflicted *narrative* damage on ourselves, and it was vicious. It’s one of the most potent economic forces that exists.

When we think about the growth of economies, businesses, investments and careers, we tend to think about tangible things—how much stuff do we have and what are we capable of?

But stories are, by far, the most powerful force in the economy. They are the fuel that can let the tangible parts of the economy work, or the brake that holds our capabilities back.

Congratulations, you're still reading.

It's time to tie together a few things we've learned.

This chapter is a bit of a summary; a few short and actionable lessons that can help you make better financial decisions.

First, let me tell you a story about a dentist appointment gone horribly awry. It teaches us something vital about the dangers of giving advice about what to do with your money.

Clarence Hughes went to the dentist in 1931. His mouth was radiating pain. His dentist put him under crude anesthesia to ease the pain. When Clarence awoke hours later he had 16 fewer teeth and his tonsils removed.

And then everything went wrong. Clarence died a week later from his surgery's complications.

His wife sued the dentist, but not because the surgery went awry. Every surgery risked death in 1931.

Clarence, she said, never consented to the procedures in the first place, and wouldn't if he were asked.

The case wove through courts, but went nowhere. Consent between doctor and patient wasn't black and white in 1931. One court summed up the idea that doctors require freedom to make the best medical decisions: "Without such, we could not enjoy the advancement of science."

For most of history the ethos of medicine was that the doctor's job was to fix the patient, and what the patient thought about the doctor's treatment plans wasn't relevant. Dr. Jay Katz wrote about the philosophy in his book *The Silent World Between Doctor and Patient*:

> Doctors felt that in order to accomplish that objective they were obligated to attend to their patients' physical and emotional needs and to do so on their own authority, without consulting with their patients about the decisions that needed to be made. The idea that patients may also be entitled to sharing the burdens of decisions with their doctors was never part of the ethos of medicine.

This wasn't ego or malice. It was a belief in two points:

ask, “What are you saving for? A house? A boat? A new car?” No, none of those. I’m saving for a world where curveballs are more common than we expect. Not being forced to sell stocks to cover an expense also means we’re increasing the odds of letting the stocks we own compound for the longest period of time. Charlie Munger put it well: “The first rule of compounding is to never interrupt it unnecessarily.”

How my family thinks about investing

I started my career as a stock picker. At the time we only owned individual stocks, mostly large companies like Berkshire Hathaway and Procter & Gamble, mixed with smaller stocks I considered deep value investments. Go back to my 20s and at any given point I held something like 25 individual stocks.

I don’t know how I did as a stock picker. Did I beat the market? I’m not sure. Like most who try, I didn’t keep a good score. Either way, I’ve shifted my views and now every stock we own is a low-cost index fund.

I don’t have anything against actively picking stocks, either on your own or through giving your money to an active fund manager. I think some people can outperform the market averages—it’s just very hard, and harder than most people think.

If I had to summarize my views on investing, it’s this: Every investor should pick a strategy that has the highest odds of successfully meeting their goals. And I think for most investors, dollar-cost averaging into a low-cost index fund will provide the highest odds of long-term success.

That doesn’t mean index investing will always work. It doesn’t mean it’s for everyone. And it doesn’t mean active stock picking is doomed to fail. In general, this industry has become too entrenched on one side or the other—particularly those vehemently against active investing.

Beating the market *should be hard*; the odds of success *should be low*. If they weren’t, everyone would do it, and if everyone did it there would be no opportunity. So no one should be surprised that the majority of those trying to beat the market fail to do so. (The statistics show 85% of large-cap active managers didn’t beat the S&P 500 over the decade ending 2019.)[71]