RESILIENCE IN MONEY

How to stop worrying about money in any situation – A summary of a presentation delivered by Justin Hooper on 18th February 2016.

THERE'S NO DOUBT **2016 started fast - but not in a good way.** The US stock market had its worst 5-day and 10-day start to a year in history. The Australian market wasn't much better. At the same time China's Shanghai market entered free fall, with circuit breakers stopping trading on January 6 after only 29 minutes. The Chinese authorities had to intervene massively.

The Middle East started to look decidedly dangerous after a build-up of tensions and a catalyst execution in Saudi Arabia that triggered a break in diplomatic relations with Iran. Then, just for some extra 'flavour' North Korea successfully tested an H bomb, and leader Kim Jong Un made veiled threats to the US.

With all these events happening at once reactions varied, but there were a surprising number of commentators advocating extreme action - including two of the biggest banks advising clients to **'sell everything'**. There's no doubt it was a time that would have tested the calmest of investors. Of course this is not the first time volatile circumstances have created fear in the markets. **In a career spanning 33 years** I have seen it many times before and on every occasion it creates opportunities for some and costs

for others. It's not whether volatile political, social and economic circumstances will occur - leading to uncertainty and fear - but rather how to deal with it **when it does**.

Whether institutions, academics, practitioners or clients, investors generally fall into one of three categories; those that are very concerned that "this time is different", those that are worried but believe it will pass and those that think it's a great opportunity to exploit panic.

WHY IT HAPPENS

Growing up in a capitalist society almost always results in at least some vulnerability to **'the Capitalist Myth': That money will make us happy**. We know that it can't, by itself, yet we still believe that we need it to give us the lifestyle that we want.

So when the world is volatile and markets are collapsing, investors start to worry about losing the lifestyle they have. The impact of the fear of "loss" stimulates the fight or flight reaction. Human beings, especially men, find it very difficult to resist trying to **'fix the problem'**. They have to do something! But this is just one aspect of anxiety around money. There are many more questions and anxieties:

"How much longer do I have to keep working in a job I hate?"

"How is it possible that my friends are able to afford what I can't?"

"Why do my investments never do as well as others?"

"Are my assets protected?"

"How will my children ever be able to afford to buy a home?"

While research conducted with families with net wealth of between $25m and $1billion showed that their two biggest concerns were:

"Will too much money have a negative impact on my children's happiness, relationships and ability to succeed on their own?"

"How do we protect and optimize our assets?"

So fear and uncertainty drives all of us for one reason or another.

HOW IT HAPPENS

To understand investor behaviour and psychology it pays to **understand the cycle of life**. This is best represented by a concept known as the "Hero's Journey". Written by Joseph Campbell, it comprises twelve stages.

But it is the first stages that help to explain why investors often feel great anxiety or panic under pressure.

The first stage is our beginnings, where as a baby we are as close to **our true self** as we can ever be.

But it isn't long before this purity encounters a 'threat to life'. Something happens which is in conflict with our 'true self'. It's a painful experience and we don't enjoy it or want to repeat it. This is **the second stage** of the journey and it is during this stage that **beliefs are formed**. We create strategies to avoid pain in the future but because these beliefs are from a limited experience, they themselves are limited and incomplete and will ultimately lead to a new, but different painful experience. This becomes the **'cycle of suffering'** and most people are unable to break out of this cycle and so continue to repeat their painful experiences

These deep seated beliefs are apparent when there is stock market volatility. A spike in 'pain' or anxiety is created and often exaggerates our response. And it is precisely at this time that some of us make big mistakes, while others snap up opportunities and a third group just sit back and watch.

HOW TO DEAL WITH IT

There are three common characteristics of the groups that don't panic.

First, they are completely convinced that no matter what happens, they will have sufficient cash flow for the rest of their lives. Second, they have complete confidence in the assets they own and third they understand how their decision making impacts their outcomes.

CASHFLOW IS KING!

If your head was being held under water, there would be only one focus – getting air. Nothing else would even enter your mind.

What air is to living, cash flow is to money. According to Tom Rath in his book "Wellness", having **the perception** that there will always be enough cash flow is three times **more important than the cash flow itself**.

THE CASH FLOW PLAN NEEDS TO BE DETAILED

Just as the first priority of an aircraft is to is to land safely (the second is to land at the right destination), so too the first objective of a cash flow plan is to show that the investor will not run out

of money and will be able to **sustain a minimum lifestyle no matter the circumstances**. To achieve this, the plan will need to document the income from all sources, expenditure by category and assets and liabilities. It needs to be extended over the expected life of the investor with some room for error.

The first element of 'weathering the storm' is to be as confident as possible that **all scenarios have been considered** and alternative plans are in place. Imagine getting on a plane in Sydney, bound for London but knowing that the flight plan hadn't mapped out alternate destinations. You would feel understandable anxiety. So there has to be a detailed cash flow plan that considers all possibilities. Scenarios such as the market falling by 15% each year for three years in a row, a major GFC type collapse and recovery or even the loss of a job and a market correction at the same time.

Any scenario that causes concern should be considered. **Confidence under pressure comes from having contemplated and planned for the worst scenarios**.

Cash flow projections are useless if the assumptions are inaccurate and one of the key assumptions is spending. In my experience, **ninety percent of people underestimate how much they spend**. Those who don't, track it. Some use pretty simple methods. Others use accounting packages which link to their bank accounts and produce fairly detailed breakdowns of spending and income and match it against the projection.

Consider that aircraft heading to London: It's impossible for an aircraft to stay perfectly on track at all times. Wind, weather and avoiding other aircraft are only some of the reasons for departure from the flight plan. However, knowing how far off track we are and constantly developing a new track is key to confidence in getting to the right destination.

When it comes to spending, it seems obvious to spend effectively, not wastefully. Interestingly **spending on experiences is more effective than spending on objects**. It is better to pay for a holiday or a lifetime experience, even a social event than it is to buy a new product. And according to Tom Rath, **there's more value in spending on others than on ourselves**.

CONFIDENCE IN QUALITY OF ASSETS

Here's a simple puzzle.

Most people immediately try to balance the nails, one at a time on top of the nail in the wood. It doesn't take long

THE CHALLENGE IS TO BALANCE SIX NAILS ON TOP OF THE ONE IN THE MIDDLE

before they realise their method is getting nowhere and they start thinking that it must be a trick or there's some missing information.

This is exactly how investors think when selecting investment assets. Very little research and analysis takes place leading to an inherent lack of confidence in the quality of their portfolio. When asset prices fall, as they inevitably do, the investor's lack of confidence becomes costly.

Back to the nails. The issue can be solved with simple logic. Most people don't think logically about the problem. They just start trying to balance the nails on top of the one nail. But it's apparent that it will require balance with an equal amount of weight on both sides.

This is how it's done.

Remarkably simple when you know how.

Asset ownership and investing are very similar to this nail trick. It too seems more complicated than it is. The process of **constructing the right portfolio** of assets for your circumstances is what will ultimately **provide you with confidence under pressure**. Similar to a bridge where opposite pressure creates strength, so too does a combination of different assets provide strength to a portfolio.

First, get the defence right. Wayne Bennett is the most successful rugby league coach in history. He doesn't do any attack training until his teams can be completely confident about their defence. Asset defence means at least **three years of lifestyle expenditure in cash**.

Then select the other assets in their own right and as combinations. Be clear about the role each asset will play and measure it against its own benchmark. Just like a sports team, each player is measured and has individual benchmarks.

There are four broad categories - **lifestyle assets, investment assets, speculative and business assets**.

Lifestyle assets are there to simply satisfy emotions. You know something is a lifestyle asset if you wouldn't sell it even if you could get a better return.

Investment assets are your workhorse. They are selected based on probabilities. They are there to do a job, to produce income and growth.

Speculative assets are based on opinion, not probabilities.

And of course **business assets need to provide an additional return** for the additional risk and the investment of human capital.

Once the asset defence is established and each asset has a role - with benchmarks, there needs to be a process for selecting risky assets. Remember at some point, these assets will fall in value and when this happens the owner's confidence will be tested. It is therefore imperative that the selection process is robust and based on probabilities.

The majority of investors purchase assets with too little analysis and then lose confidence too easily. (A balanced portfolio that had been a wonderfully consistent performer over many years came a little unstuck last year. But that doesn't mean it's wrong).

It is absolutely certain that your portfolio will come under pressure at some time. When it does, it will be the knowledge that there is sufficient cash flow for at least three years and that each asset is of the highest quality that will provide the confidence to hold or opportunistically allocate further assets.

BAD DECISIONS COST US ANXIETY AND MONEY

Human beings make bad decisions and it's often costly.

In fact we are wired to make bad decisions! Much has been written about this topic but the understanding of behavioural finance is still in its very early stages. There's still a lot to learn but what is known is that a cocktail of fear, social proof and conflicts of interest will lead to significant and unnecessary cost.

A recent Dalbar study showed that **the average investor costs themselves around 4% per annum** or $40,000 on a $1m portfolio - every year!

As common as they are, these errors are avoidable. Some simple techniques could save you significant amounts of money.

FIRST FOCUS ON AVOIDING BAD DECISIONS BEFORE TRYING TO MAKE GOOD ONES.

It's surprising how a focus on **eliminating bad decisions will improve overall, long-term performance**. In fact, a common request from wealthy investors of their advisers is 'stop me making stupid decisions'. Investors find inaction very difficult.

However, the old cliché, "I'd rather apologise for something I did than regret doing nothing" often explains why investors (particularly men) make bad decisions rather than do nothing - and it costs them dearly. Even Warren Buffet, the world's most successful investor has often admitted to **his shareholders that they would have been better off had he done nothing**.

Consider the research conducted by economist Ofer H. Azar at Ben-Gurion University of Negev in Israel on goalkeepers attempting to save penalty kicks. It showed that on average they saved 1 in 5 penalty kicks. Goalkeepers usually try to anticipate which way the ball will be kicked and dive early. However, the research showed that a big improvement in success (up to 1 in 3 kicks saved) could be achieved if the goalkeeper just stood still! So why don't they do it?

Because **they fear being**

criticized more than they fear failure. If they stand still and the goal is scored, it seems like they didn't try. Even though it's both irrational and has a higher probability of failure, they'd rather been seen to have tried.

It seems even worse when the risk is being taken for no particular benefit. Most people are happy with their current lifestyle and even more money wouldn't change that. Yet illogically, they risk their current lifestyle whilst not wanting to change it. Why take risk if you don't need to?

Another 'bad' decision is an 'unconscious' one: The decision-maker hasn't contemplated all the circumstances within which the decision is being made. They are simply making a 'lazy' decision. Issues such as conflicts, costs, purpose and alternatives are ignored in the interests of a quick decision.

Slowing down decision making can be a very powerful and simple method to improve overall returns and reduce the likelihood of making avoidable errors.

SECOND, BE AWARE OF YOUR MONEY IMPRINTS AND FRAME OF REFERENCE.

A frame of reference is both internal and external. The internal frame is developed over time and is up to fifty percent genetic. The rest is developed from social interactions and personal experiences. It's subconscious and it is within this frame or comfort zone that decisions are made.

For most of the time it's dormant but when emotions are heightened, the framework becomes more prominent and can lead to risky decisions.

If it comes to a challenge between your framework and a strategy, under pressure your framework will win.

THIRD, AVOID COMMON BEHAVIOURAL ERRORS BY ENTERING INTO A ULYSSES CONTRACT WITH A TRUSTED SOUNDING BOARD.

Your mind can play tricks on you and it's easy to make behavioural errors. We are not always rational, especially around money. Mistakes are part of the human condition, but those investors who are aware of this are able to neutralise those mistakes. They will be supremely successful investors.

Some of the most common errors include:

- **confusing plausibility with probability** - human beings make up stories around a set of facts
- **being unable to withdraw from a bad idea** (the sunk cost fallacy) – we often persevere with something even though we know it's a loser – also known as irrational perseverance
- **trusting 'gut feel' to make important decisions** - studies show that it only works when there is a short feedback loop and frequent occurrence
- **making decisions based on a powerful** memory of a past event rather than the probability of its recurrence.

What's needed is a set of rules - and a sounding board. Rules, if adhered to are highly likely to result is a successful outcome over the long-term. While someone acting as a sounding board can keep the investor focused.

This could be known as a "Ulysses Contract". Named after the Greek mythology in which Ulysses, whilst venturing in his boat was so concerned that the lure of the mermaids' siren songs would cause shipwreck, that he had his men put wax in their ears. He commanded them to tie him to the mast, to stay on course and to attack and kill him if he broke free.

When they came, the mermaids' song made Ulysses go temporarily insane but because he couldn't move he saved himself and his men. The siren song of asset prices as they rise and fall will heighten our emotions, which together with media noise can cause us to lose our senses – and our money!

The "Ulysses contract" is a combination of an Investment Policy Statement and trusted sounding board.

Warren Buffett, even though he is regarded as the world's most successful investor is almost more well known for his 'rules'. Buffett also attributes much of his success to his friend and sounding board, Charlie Munger.

There has never been a successful person in history, in any walk of life, who has been successful on their own. Every successful person has at least one trusted adviser, someone who knows them well, who is not conflicted, and who has strong knowledge and ability. Someone who will tell them the truth and keep them focused.

There are many people with varying degrees of wealth who have at least some concerns about money. As we have seen, **the first step to eliminate or reduce concerns about money is to use logic**. If the concerns are logical, then action

can be determined and acted upon. You and your investments are on solid ground. If not, your actions will be based on psychological or behavioural factors, and your assets - and your lifestyle - may be washed away.

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