EPISODE 799

[INTRODUCTION]

[0:00:35.1]

FT: When it comes to investing, you've probably heard the phrase, 'Buy what you know.' Do you believe it? I'm asking because today's guest believes that is "profoundly dumb advice." Welcome to So Money everyone. I'm your host Farnoosh Torabi.

I mean, I think that's sort of good advice, buy what you know, don't get into something you know nothing about, bitcoin. But today's guest, Dr. Daniel Crosby, he's a New York Times bestselling author, he's a psychologist, behavioral finance expert, asset manager. He thinks that is not sound advice.

He was last on the my show, you might remember on Episode 453 about two years ago but he's back with a new book. His book is called the *Behavioral Investor* and in it, he examines the sociological, neurological and psychological factors that influence our investment choices. He believe that you know, we should first understand human nature and our own tendencies before making investment decisions.

A little bit more about Daniel, he's a sought after expert, frequent speaker and he was named one of Investment News' 40 Under 40 and also, a financial blogger, you should be reading by AARP. We'll learn more about Daniel's philosophies around how to invest well, how to curb our emotions and Daniel publishes this irrationality index, it's a measure of how much greed and fear is in the marketplace month to month, so we're going to find out, here we are, October. How greedy are we this month?

Here is Dr. Daniel Crosby.

[INTERVIEW]

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FT: Dr. Daniel Crosby, welcome back to So Money.

[0:02:13.5]

DC: Thanks, wonderful to be back.

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FT: All right, got to ask you about this conventional wisdom, piece of conventional wisdom that you just don't like. You think it's baloney. Peter Lynch's strategy, buy what you know. Which I heard a lot of people say, not just Peter Lynch. But it's become sort of this accepted mantra when it comes to investing, you think that's profoundly dumb advice. So should we be buying what we don't know, how does this work?

[0:02:40.4]

DC: Yeah, I mean, you actually should. We're prone to a number of predictable biases and one of them is sort of an adherence to the status quo or confusing what we know with what's safe. You know, we tend, when we're confronted with a tough question, we tend to answer an easier question. When we're voting for president, we don't say, who has the sophisticated foreign policy. We say, who would I like to have a beer with.

And when we are picking a stock for making an investment, we don't tend to say, you know, is this – does this have a place in terms of risk adjusted returns and portfolio. We tend to ask questions like, "Have I heard of it?"

What we see is, for example, during the Greek debt crisis, Greek investors had over 90% of their wealth tied up in Greek companies. You know, Greece accounts for like a 1% of the international equity market, the Greek investors had almost all of their money there. Even within the US, we see people in the northeast tend to be over weight financial stocks, people in the Midwest tend to be overweight agriculture stocks.

We see time and again that people tend to vastly over weight their own company stock within their portfolios. Yeah, this is something we're already doing, we don't need nudges from billionaires to make us do this because we already do this to our own determent.

[0:04:07.9]

FT: It sounds like what's also not happening in those scenarios were whether you're living in Greece and you're putting all your money in the Greek economy or you're working at a company and putting all your money in the company stock. You're not diversifying which is not the same as buying what you don't't' know but it's really another principle of investing which I hope you still think is right. I think that's still valid advice, right? You should diversify?

[0:04:32.6]

DC: Yeah, of course but you know, I think a lot of people know what this is but they don't know what it looks like. We know we're supposed to diversify but very consistently, we'll see people with you know, 10 different mutual funds of large cap US stocks. Well, that's not diversified, you might have 10 different mutual funds and you know, 200 different stocks but they all kind of fit the same flavor profile, you know? Another thing that you see people do, sometimes people with lots of wealth will work with two different banks or two different advisers, that's not necessarily diversifying either.

We need to make sure that we're diversified within and between asset classes. Within a given asset class, stocks, bonds, commodities, whatever You need to have a diverse set of holdings but you need to also hold multiple asset classes that tend not to move in tandem with one another.

That's tricky to do and something that I think most people don't have a very practical understanding of.

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FT: Well, we started off with some heavy hitting advice and I think let's take a step back and you know, talk a little bit about how you've been over the last couple of years since we had you on the show, back then, two years ago, you had just launched a book, the laws of wealth and in the interim, you've become more interested in exploring human behavior and investing.

What brought you to this new book, this latest book, the behavioral investor and let's talk about that a little bit, I want to catch up.

[0:06:15.0]

DC: It's been a great couple of years, had another kid which will hopefully be my last.

[0:06:20.7]

FT: Congratulations.

[0:06:23.3]

DC: Yeah. I had a third and final child, the laws of wealth was named the best investment book of 2016, it was a huge honor and it was translated into six different languages so wildly successful book thanks to appearances on this podcast of among other things. The thing that gave rise to the behavioral investor was anger, was frustration.

[0:06:53.0]

FT: You have rage too? Tell me about your situation?

[0:06:57.1]

DC: Yeah, it was rage, this is a rage baby. What gave birth to the behavioral investor was being at a conference in San Francisco and being on a panel with a number of sort of self-styled investment coaches and this would be, you know, sort of coaches for day traders so to speak

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and being on this panel with these individuals and hearing some of the folk wisdom and untruths that they were speaking about or sort of pop psychology or bad science.

I thought, you know what? There's still more work that needs to be done around the brain, around the body, around society and how all of these externalities in pinch on our ability to make good decisions. Yeah, this new book was trying to cover some new ground and also trying to set the record straight on some popular misconceptions like you know, like the Peter Lynch thing of buy what you know, it sounds sensible but it's actually quite dumb when you understand human psychology a bit.

[0:08:01.8]

FT: What else gets under your skin? What else is a pet peeve of yours when it comes to this pop science, conventional wisdom around money and investing? What else?

[0:08:13.2]

DC: One of the biggest ones is around emotion. There's actually a lot of nuance around emotion as a variable when making financial decisions and this was a particular frustration that got me going that day. But we see that on the one hand, emotion is necessary to make most decisions. When you look at people who have damaged to the emotional processing centers of their brain, they have difficulty making even, very day to day decisions about you know, what flavor of ice cream do I choose or you know, what color suit do I wear.

Because even very low stakes decisions have an emotional undercurrent that I don't' think we always recognize and so because of this, some of these coaches and some of these folk wisdom will say, well, if emotion is part of most decisions that we make then you know, tapping in too this emotional sort of sixth sense will be a form of investment alpha for you, this will be an in form of investment out performance.

But every single study I could find yearly points to the fact that emotion is at best not very helpful when making investment decisions and at worse, quite damaging. In the book, I talk

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about studies that I thought were fascinating where we found that bilingual people make better financial decisions when they are thinking in their none preferred language.

If you are bilingual or trilingual and you have an important financial decision to make, reasoning through that in your none dominant language actually causes you to slow down, be more deliberative, be less emotional and as a result, these people made really good financial decisions relative to people who are thinking and deciding in their dominant language because it mitigated their emotional response.

Another thing they found is that these brain damaged patients while they weren't very good at picking out ice cream, they were very good at gambling and investing because they were emotionless, they just weighed probability, they looked at the numbers, they have no fear, they didn't get gun shy after a loss and they just kept at it.

I'm a big time believer based on everything I've read that emotion is A, sort of inevitable in all facets of life but when it comes to financial decisions, you're much better off sort of mitigating your emotional response rather than tapping into it as sort of some mystical sixth sense and means of intuiting what to buy.

[0:11:09.2]

FT: Again, how do we mitigate it? Short of becoming brain damaged, how do we do this on our own?

[0:11:15.8]

DC: You learn a second language – no. The way that you do it, a big beans by what you do, it's just by automating it. I mean, this is why automating is incredible. It allows you to set it and forget it so you make the good decision one time and you never have to think about it again. That's you know, one thing that you can do, the second thing you can do is to work with a professional who you select among other things based on their ability to keep your emotions in check.

You know, I think when you're looking for a good advice or you want to look at their fees, you want to look at their ethics but you also want to look at your connection with that person and ask yourself. Do I like them? Do I connect with them enough that I'm going to allow t hem to talk me off the edge?

Another thing is to use a rules based process to decision making so that if things go sideways, you can blame the model instead of blaming yourself. All of these are sort of simple but effective ways to manage emotion.

[0:12:23.7]

FT: What's your take on index funds? That's also something that we have adopted and it's become widely accepted as the way to invest especially for people who don't have an interest or time in managing their own stock moves and frankly, there's a lot of studies out there that say, just passive investing, you know, it gets you to the finish line, don't need to pay big bucks for someone to be going in there and making moves every day, every minute, day trading, forget it. Do you have a different philosophy on that?

[0:12:59.0]

DC: It must be said that index funds are the right choice for nearly everyone and index funds are the right choice for everyone who just wants to worry about more important stuff. You know, one of the disadvantages of talking about money all the time is that in a very real sense, you get mired in all the fear monger bring in concern, that's the enemy of good investing. For people who want to set it and forget it. I think index funds are a wonderful choice.

In each of my last two books, I get a little more granular with this and I tried to do it in such a way so that I would frustrate proponents of both indexing and more active forms of management. I thought that was a fair way of everyone left upset and in bitter, I felt like I had sort of done my job and that's what I shot for.

The longer answer is, I think the indexing can be improved upon and so, you know, what we want to look at is the things that indexing does well. I think it manages fees, it's highly

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diversified, it's low turnover. There are other ways to manage your fees, manage your turnover and get diversification that I think are probably slightly superior to just regular market cap index based indexing but if you don't care about finance, you could do much, much worse and not much better.

[0:14:37.2]

FT: Copy that. Wow, all right. Now, Daniel, it is October and I know that you and your team, you guys put out this irrationality index, do you still do that?

[0:14:49.7]

DC: Yeah.

[0:14:50.6]

FT: All right. It's basically measures the greed and fear in the marketplace for month to month. How are we doing in October or I guess September? Since you lasted it?

[0:15:03.9]

DC: Sure. We put out two in the Cs, one is around evaluations of the broad US stock market and one is around irrationality as you said. In very recent terms, we have been both highly irrational and highly overvalued. It's not a, you know, we're on day, whatever day it is, say four or five now of some pretty choppy market and so, both the irrationality index and evaluation index have been in the top quintile for the last couple of weeks.

This is where again, no one listening to this should go out and sell everything and you know, buy guns and gold but this is where we start to worry a bit. Because there's – when both of these things are at play, it gets a little troublesome because evaluations are expensive by historical standards and things are getting a little choppier and when we tend to see a lot of chop with some very steep evaluations like I believe we have today.

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It's kind of a recipe for bad things. Of course, those bad things only materialize about one time in three when those conditions are met. Still, the safest thing to do is to just stay the course and let it ride but I mean, I'd be lying to you if I thought we were going to get 10% a year equity returns for the next 10 years just because of how good things have been for the last 10 years.

You know, these things tend to level out over long periods of time and so I think investors need to moderate their beliefs, need to steal themselves for a five to 10 year period of returns that haven't been what they've been for the last 10 years and the tricky part about human nature is we tend to project the recent past into the future indefinitely.

If you ask someone, you know, in March of 2009, you know, what will the market look like five years from now, they'll say well, it's probably just going to keep crashing because it had been crashing, well of course, it's done great and if you ask someone today, when the market's been up about 15% a year for the last 10 years, you know, what will the market look like three or five years from now. I think they'd suggest that it'll still be blowing the roof off and that's, you know, not impossible but it's less likely to be the case.

[0:17:48.2]

FT: Right. I believe that's called recency bias, is that right?

[0:17:51.7]

DC: Yeah, that is called recency bias and you know, in my last book, *The Laws of Wealth*, I tried to pinpoint, the one phrase that's always true in investing and I think the one thing that we can always say in considering capital market is this too shall pass so whether you're going thorough something great or something horrible, we know that it will pass and part of being a great investor is having the mental toughness to see it through the best and worst of times.

[0:18:26.3]

FT: Daniel, last you were on this podcast was two years ago, episode 453. Listeners, if you'd like to learn more about Daniel's personal money beliefs, his personal money wins and losses,

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it's all there, Episode 453 but I do want to ask you one personal question while we have you on the second time here and it's with our sponsor and mine. Chase Slate who is a great sponsor of this show and we thought we fund, for the month of October to ask guest to describe their scariest –

Because it's Halloween almost, money moment.

[0:19:00.3]

DC: So my scariest money moment anytime I am asked about my dumbest decision or scariest decision, it is the house from which I am currently addressing you is my dumbest.

[0:19:16.7]

FT: Really?

[0:19:17.9]

DC: Oh for sure.

[0:19:19.7]

FT: And you live in?

[0:19:21.8]

DC: Georgia, in Atlanta.

[0:19:22.7]

FT: Georgia, okay.

[0:19:24.8]

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DC: So yeah, this is going to fall on deaf ears to the New Yorker but yeah, we bought a home. We wanted to move to a bigger market. I am from Alabama originally and my wife who is from Connecticut was very good natured about living in my home town for six years but we wanted to move to a bigger market, better airport and so we bought a big expensive by Georgia standards house without having sold our house in Alabama which I mean we could.

We could afford it, it was fine but keeping up two houses and the upkeep, the hassle, we rent out that second house but the up keep, the hassle, the unexpected expenses, the taxes that we didn't fully consider all of it has sucked. I mean it has just been – I want to say the only thing that it has ever done good for our finances is it's cured me of my former desire to have a vacation home. So having two houses and thinking that a house will make you happy.

Thinking that a house is going to really materially change our life is probably my scariest moment and my dumbest decision incidentally that ignored pages and pages of my own writing and research.

[0:21:02.0]

FT: So here we go, another bit of conventional wisdom that ownership is the path to wealth, home ownership and I think that some people are adamant about that through experience and others like yourself are like, "Oh I am not so sure about that," through experience. Would you go back in time and rent or would you sell the second home and how would you do things differently?

[0:21:27.5]

DC: I would definitely sell the first home before buying a second home. Now we've ended up renting it out because the market there has been soft and it is okay, we make a little money on it each year but the amount of money that we make relative to the pain in the neck that it is out of whack. So I think people need to understand a couple of things about houses because there is a couple of behavioral things that we get wrong about houses pretty consistently.

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One of them is we fall prey to the money illusion, Robert Shiller looked at a 100 years of American housing improvements and appreciations and he found that housing appreciates about at the same rate as inflation. So you know about two and a half, 3% a year but the people that he's surveyed expected their house to appreciate a 13% a year. So people think a house is a great investment. It is really not like it is a good place to stash money.

If you are worried you are going to touch it otherwise but that is about it. Most houses outside of perhaps San Francisco and Manhattan, they are just not great investments historically and so the second thing I think people need to understand is that they engage in something called the money illusion like we hear the story about grandma buying her house for a $100,000 and selling it 25 years later for $500,000 and we go, "Wow grandma hit a five bagger on her investment," but we –

[0:23:12.7]

FT: Never put grandma and five bagger in the same sentence again okay? That is my advice to you.

[0:23:18.2]

DC: This is good life advice but yeah, we don't account for the opportunity cost. We don't account for the taxes, we don't account for the upgrades and the new sinks and the leaky ceiling and we just don't account for all of these stuff because when it is all set and done, houses are not by enlarge a good investment and you know the final thing is that people think that a home will change their lives.

The first time we walked through this home which is a beautiful home, the first time we walked through it we were just blown away at how stunning it was and now, it is just where I throw my dirty socks and where my kids leave their toys on the floor. It is just my house, it is just the backdrop against which you live your life. So it is human nature to get used to whatever situation you are in. So your house very, very quickly just becomes the scene that get with your backdrop against which your life plays out and it is not a great source of investment return or for that matter, happiness.

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[0:24:28.2]

FT: Well I don't know I think I get the investment return for most of the country. I can see where it is iffy. I love being a home owner and I just redesigned our dining room, I continue to find a lot of pleasure in the upkeep of the home. Not so much the maintenance but sprucing things up, remodeling, changing up my kid's bedrooms as they get older because now they need a different configuration and I feel very proud of the home that we have.

And I think that it is true to a point. This is the first time I've actually felt this way. I've owned homes in the past and my studio apartment when I was in my 20s was just a backdrop because I was working so much. I barely use the kitchen, I basically went there to shower and sleep but I work from home now. So I find new and more meaningful experiences in being a homeowner and so for that reason, I'm way attached to my house.

Really attached to it and with that said, I am constantly looking at real estate listings because that's just me but I think that it is a personal – hopefully you can have that emotional attachment because it is a great thing to feel that way. I will be the first to admit.

[0:25:48.3]

DC: Well I've perhaps been overly negative. I mean I love our house too. I think we will lump it in with what I will call the move to California sentiment. You know a lot of people will go, "You know my life would just be a little bit better if I lived in California. You know the weather would be better, it would be sunnier or whatever and then you know, we find that people who move to California are about as happy as they were in Iowa because wherever you go there you are.

And so a house is lovely and I have great memories of my family and my house here provides me a safe and a quiet place to work and be on Farnoosh's podcast. So that's all good stuff but it is just not a panacea I guess is what I would say.

[0:26:40.7]

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FT: Yeah, it is not a trip around the world but that is just human nature. Is that human nature, I am guessing here that we are easily dissatisfied or eventually dissatisfied or there is a diminishing return on most things that we arrive at, accumulate purchase. Can money lead to any sort of happiness? There was a study that recently came out that said it can despite all their studies. Where are you right now on that money happiness continuum?

[0:27:15.0]

DC: Yeah, so I have read that in all the studies on money and happiness and the best way that I can summarize it is to say that money can buy the absence of sadness. I think that is what most of the research points to because if you have to live in a dangerous neighborhood or you can't pay for your surgery or you can't buy nutritious food that is actively bad. That is going to actively bring sadness and diminish quality of life to you.

Now once those things are covered like once you have a safe place to live and a roof over your head and food in your belly, money has done its job at that point and the rest is more or less up to us and there are increasing – there is increasing quality of life with more money. It just drops off very dramatically after a relatively low number around 75 to $80,000. So people who make $750,000 are happier than people who make $75,000 a year but they are not a ton happier.

So the best thing that money can do is keep you safe, warm, dry and fed and then after that, the rest is up to you and it is going to have a great deal to do with your choices in your relationships.

[0:28:37.4]

FT: Agreed. I just tweet because I am a good multitasker what you just said that money can buy the absence of sadness. That is a really interesting way to look at it but you are right, it can pay for these necessities that we need the basic life necessities and from there it is really about human choice. How you spend your money after that. I think the trick is to afford the stuff that does align with what you actually desire and value and that sounds like it's a no brainer but a lot of us has no idea what our values are.

[0:29:12.0]

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DC: Yeah, there is actually cool research around that as well that showed that money could buy happiness if it's around exactly what you said, your values. I had forgotten about that study. You know they would give people personality tests and see who are you, what's important to you, what do you value and if you spend money around the things that are most important to you then it can buy happiness.

You know my birthday is next week and I always ask my wife to get me a project. So this year, she's getting me all of this books and notebooks and journals and pens and things around writing fiction because that's something I really want to do, you know, a little money that will buy me a lot of happiness because it will be a new project for me.

[0:30:02.5]

FT: And, I just took a six week comedy course, it was $500 and it continues to be the thing I look most for to practicing, writing, performing, people asking me about it. It's nice to have something to talk to people about that has nothing to do with money.

[0:30:20.5]

DC: Yes.

[0:30:21.8]

FT: You know? Makes me feel like I'm really doing this whole life thing right because once you need something outside of work and family, you need a creative outlet and I feel a little late to it but it's better now than never.

[0:30:39.7]

DC: It's on my bucket list as well and it's been my greatest frustration that your Instagram stories have not shown the actual jokes that have just shown you on stage and I got to see the routine.

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[0:30:52.3]

FT: Yeah, well, I Know, I'm also a marketer Daniel, you got to – I can't give you all the goods online, I got to sell tickets, okay? There's an economics to being a comedian, here's the economic situation. If you want to actually rise up the – the ranks get stage time and unfortunately, it doesn't really have a lot to do with how good you are, I mean, certainly, if you're great they can't wait to put you on the stage but if you can bring friends, you're going to get stage time.

Every amateur act I've been invited to perform at, they say to me, bring your peeps, six to eight would be great and sometimes they don't put you on the stage if you go there without a friend in the audience because they want to make money. Unfortunately, that's sort of how it works so you won't be seeing my jokes is what I'm saying for a while.

[0:31:45.7]

DC: Well, I will fly up there to make it happen in person. I have a couple of friends who I consider some of the smartest, funniest people I know online and seeing them do standup comedy and between the two of us just bomb, doing standup comedy really gave me a sense for how difficult it is and what an art it is because these folks are extremely talented and very bright and seeing them struggle on stage, it was really something.

[0:32:16.7]

FT: I have the reverse problem, I'm not smart or talented but I'm okay on the stage. I can just stand up there and talk and if people are booing, I'll just stand there and I'll keep doing my act. I have that. I have the reverse problem which is actually writing good material butt I'm working on it. Hope to see you at a performance and Daniel, congratulations on the latest book, *The Behavioral Investor*, also becoming a new dad. My goodness, you get a lot done in two years.

[0:32:47.2]

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DC: Yeah, I can't take much credit for the baby but the book's all clean.

[0:32:52.6]

FT: Fair, yes, your wife gets all the credit, I agree with that.

[0:32:55.7]

DC: That's right.

[0:32:56.6]

FT: Thank you so much and hope to have you back when you've got a third – well, a fourth book. This is your third book or your fourth?

[0:33:02.6]

DC: Yeah, this is my third book.

[0:33:04.8]

FT: Your fourth book and then your fourth baby, you can come back on the show.

[0:33:08.5]

DC: Fourth book, we're going to keep the babies we've got but thank you for having me.

[0:33:11.7]

FT: You're welcome.

[END]

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