Chapter 1

Why Reaching Financial Goals Is Difficult

I'd like to live as a poor man, with lots of money.
—Pablo Picasso

Why are so many people across the United States and other developed (and currently developing countries) in a position to accumulate wealth but have such a difficult time doing so? More often than not, the reason for this failure is that one's own financial choices and behaviors sabotage otherwise well-intentioned efforts to achieve stated financial goals—assuming one's goals are stated. For the purposes of this book, we will leave aside any discussion of the current outlook for the global economy, take no notice of the wealth distribution or wage levels, and stick primarily to the subject of personal financial management.

Intuitively, most people know that saving money is a good thing, but our desire for material goods and spending on services often overrides otherwise good instincts. Understanding why behavior is so difficult to control is actually quite simple—it is a lack of self-discipline driven by psychological and/or environmental factors—but the solutions are often complex and illusory. Later in the book, we will examine some of these complexities in detail and attempt to find solutions. In this chapter, however, we start by examining some simple examples of self-defeating behavior, two of which are nonfinancial and three of which are financial examples. By doing so, we gain a common understanding of the challenges involved in controlling behavior and emphasize the importance of why behavior must be carefully managed. At the end of the chapter, I provide information about how this chapter relates to the other two chapters in this section, as well as some comments.

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NONFINANCIAL EXAMPLES OF SELF-DEFEATING BEHAVIOR

In order to get a clearer understanding of self-defeating behavior in the financial realm, it can be helpful to see examples of nonfinancial self-defeating behavior. The following examples are intended to be generic and purposefully not meant to shed a negative light on anyone matching this description.

Example 1: The Yo-Yo Dieter

Everyone knows someone who is overweight and has tried on numerous occasions to lose weight but has not been successful. I'm not talking about the rare individual with such a severe problem that gastric bypass surgery or other drastic measure is needed, but rather the person who is 30 to 50 to 100 pounds overweight and systematically fails at weight loss. And I'm also not talking about the uneducated person who does not know the amount of calories contained in food or the unhealthy effects of carrying around extra pounds. The people I am considering know that what they are putting into their bodies is what is making them overweight.

These unfortunate folks have often been traveling on a yo-yo or riding on a rollercoaster of diets: losing pounds then gaining pounds, gaining then losing, and back again. Through the dieting process, these people get educated on the calorie count of food and, by doing so, consciously know how much extra food is going into their bodies in terms of calories they eat per day. They also know that they don't eat enough fruits and vegetables (or none at all) or exercise enough (or not at all). Attempts at a quick fix are therefore attractive, however unsustainable these types of diets may be. We've all heard about diets such as all meat or no meat or a host of others that work for a while but eventually fail as the old behaviors and the accompanying pounds come back. At some point these folks just give up and say to themselves that they can't do it, and they just go on with life with the extra pounds. There are a number of psychological and physiological reasons for overeating. Although the following list[1] is targeted at women, and may not be completely exhaustive, it contains some key reasons why people overeat (and much of the information is applicable to men as well).

- Boredom: You eat when you're bored or do not have anything interesting to do or to look forward to. TV is a favorite pastime, especially when you are alone at home and bored. When food commercials are running 200 images per hour into our cerebral cortex, it is difficult not to be drawn toward the refrigerator. If food commercials are a trigger, you should watch nature shows or commercial-free TV.

- Feeling deprived: You feel deprived of the foods you enjoy, which leaves you craving for them even more. The media's attitude toward emphasizing thinness as the ideal has led to restrictive dieting and avoidance of entire groups of foods. Unfortunately, because the foods we are urged to avoid are abundantly available, and food visibility and availability are powerful eating stimuli, restrictors often break the plan and eat forbidden foods. Once this happens, overwhelming guilt followed by feelings of low self-esteem motivate the individual to go on overconsuming the avoided food in an attempt to numb these negative feelings.
- Glucose intolerance: This is a physiological trigger. In a healthy body, carbohydrates are converted to glucose and a blood glucose level of ~60–120mg/dl is maintained without thought to the dietary consumption of carbohydrate. In the glucose intolerant population, carbohydrates are readily converted to glucose, and the pancreas responds to this shift in blood sugar by secreting an excessive amount of the hormone, insulin. Insulin's job is to remove the glucose from the blood stream and help it to enter the body cells. If done properly, the blood glucose level returns to the normal range regardless of the amount of carbohydrate consumed. If this system is not working correctly, a quick rise in blood glucose followed by an over-production of insulin occurs. The excessive insulin is not recognized by the body cells so it is unable to remove the glucose from the blood stream. The result is an increase in blood insulin levels, which has an appetite stimulating effect. The person is driven to eat, and if simple carbohydrates are chosen, the cycle continues.

Other factors include a lifestyle that is constantly draining your energy; desire for comfort, feelings of being overwhelmed, upset, or hurt; and the big kicker: a lack of will power. Whatever the case, the basic facts are that there are too many people who know what they need to do to cut weight but cannot find the behavioral tools to succeed. This, naturally, is in contrast to the dieter-exerciser who eats right and exercises regularly and manages to get weight under control. It should be simple, right? For the record, I am a few pounds overweight and am guilty of several of the behaviors mentioned here, but the difference is that I am doing something about it, because I realize that *I* am in control of my diet and exercise and not the other way around. Figure 1.1 illustrates that as we age our weight is destined to go up (there are those who manage to keep it off their whole lives but not that many!). However, if we stick to a healthy diet and exercise frequently we will likely keep to a more even weight loss and, if we do, we will likely weigh less than those who are on the roller coaster. Easier said than done! (See Figure 1.1.)

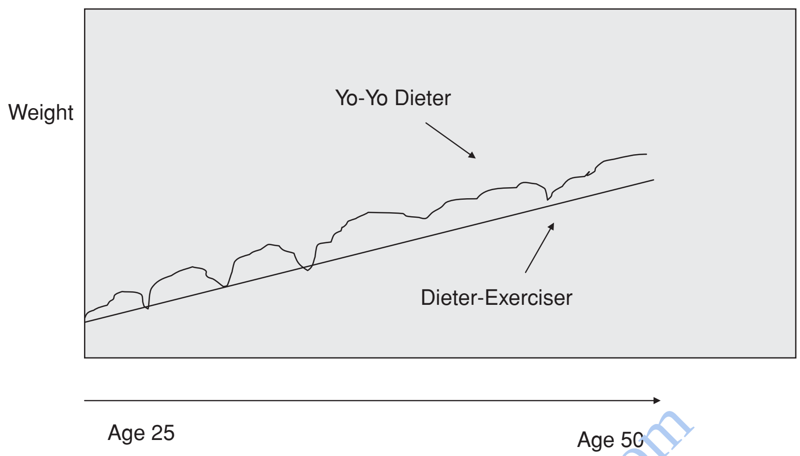

FIGURE 1.1 The Dieter-Exerciser versus the Yo-Yo Dieter

Example 2: The Educated Smoker

Have you ever met a doctor or other health professional who is also a smoker? This one sort of astounds me. How can it be that a person who has devoted their lives to the health and well-being of others can treat their body so carelessly? I can remember that, as a teenager, I would play sports with my friends in my backyard and witness my next-door neighbor, a doctor, chain-smoking on her porch. I knew even at that age the health risks of smoking and I could not understand for the life of me why she smoked (I knew *she* had to know the risks involved). Later, when she was in her forties, I heard she had died of lung cancer. This shocked me, but when I thought about it I realized it shouldn't have come as a surprise. To this day, I still remember a poster in the hall of my middle school that showed an elderly, wrinkled, lifeless person holding a cigarette with the caption "Smoking is very debonair" across the bottom, which was meant to deter youngsters from smoking. It was shock treatment at an early age, and it worked. So how is it that a well-trained doctor, with full knowledge of the health risks of smoking, chain-smokes him- or herself to an almost certain death? As with the yo-yo dieter, there are psychological as well as physiological reasons why people who know smoking is bad still engage in the act.[2]

For many people, smoking is a reliable lifestyle coping tool. Although every person's specific reasons to smoke are unique, they all share a common theme. Smoking is used as a way to suppress uncomfortable feelings, and smoking is used to alleviate stress, calm nerves, and relax. No wonder that when you are deprived of smoking, your mind and body are unsettled for a

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little while. Below is a list of some positive intentions often associated with smoking.

- Coping with anger, stress, anxiety, tiredness, or sadness.
- Smoking is pleasant and relaxing.
- Smoking is stimulating.
- Acceptance: being part of a group.
- As a way to socialize.
- Provides support when things go wrong.
- A way to look confident and in control.
- Keeps weight down.
- Rebellion: defining self as different or unique from a group.
- A reminder to breathe.
- Something to do with your mouth and hands.
- Shutting out stimuli from the outside world.
- Shutting out emotions from the inside world.
- Something to do just for you and nobody else.
- A way to shift gears or changes states.
- A way to feel confident.
- A way to shut off distressing feelings.
- A way to deal with stress or anxiety.
- A way to get attention.
- Marking the beginning or the end of something.

The National Institute on Drug Abuse (NIDA) reports that people suffering from nicotine withdrawal have increased aggression, anxiety, hostility, and anger. However, perhaps these emotional responses are due, not to withdrawal, but to an increased awareness of unresolved emotions. If smoking dulls emotions, it's logical that quitting smoking allows awareness of those emotions to bubble up to the surface. If emotional issues aren't resolved, a reformed smoker may feel overwhelmed and eventually turn back to cigarettes to deal with the uncomfortable feelings.

Instead, when you smoke, the carbon monoxide in the smoke bonds to your red blood cells, taking up the spaces where oxygen needs to bond. This makes you less able to take in the deep, oxygen-filled breath needed to bring life, to activate new energy, to allow health and healing, or bring creative insight into your problems and issues. The bottom line here is that once again, even though it is well known and documented that smoking is an entirely unhealthy activity, there are a myriad of reasons why people smoke. Self-defeating behavior is the culprit; intellectually, we know that smoking is bad. But somehow the will to stop just isn't there.

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FINANCIAL EXAMPLES OF SELF-DEFEATING BEHAVIOR

Now that we have reviewed some nonfinancial examples of self-defeating behavior, we can turn to financial examples of behaviors that should be equated with poor investment performance but are repeated by investors month after month, year after year, cycle after cycle.

Number 1: The Return Chaser

One of the most basic of human investment instincts is to be in the know regarding the latest investment trend. How silly we feel when we are at a cocktail party or barbeque in our community and we join a conversation in progress about how your neighbor just made a killing on XYZ stock that participates in ABC hot industry. Why am I not participating in this money making opportunity, you ask yourself? This occurred with Internet stocks in the late 1990s and then with real estate during the subsequent decade, and now back to the Internet bubble of the late 1990s with social networking companies that are creating, in my view, another irrational valuation bubble that some investors wish they could be involved with and, undoubtedly, someday will be glad they never invested in.

At one time or another we have all seen someone who epitomizes this type of investor—or maybe this is our own behavior! These folks follow the latest trend, paying no attention to valuation. They have no rational basis for making an investment and jump in without an exit strategy, or they plan to get out when a profit has been made, if one is ever made. The investment may go up, but since no plan is in place, the investment ultimately turns sour and losses ensue.

As investors, we must resist the urge to participate in such schemes and steer clear of these money-losing opportunities. Our own behavior is often the culprit, and we need to overcome our natural instincts to participate in less-than-rational investment schemes, or at least we should have an exit strategy if the decision is made to participate. Later in the book we will look at individual behaviors that account for chasing returns, as has been described here, and devise strategies for overcoming these behaviors.

Number 2: The Overconfident Gambler

It is not uncommon to come across the type of investor who thinks they are smarter than the average market participant, who enjoys the thrill of trading in and out of the market (like the thrill associated with gambling), and is more often than not on the losing end of the trade (with the occasional win to keep them in the game). And being on the losing end of the trade often

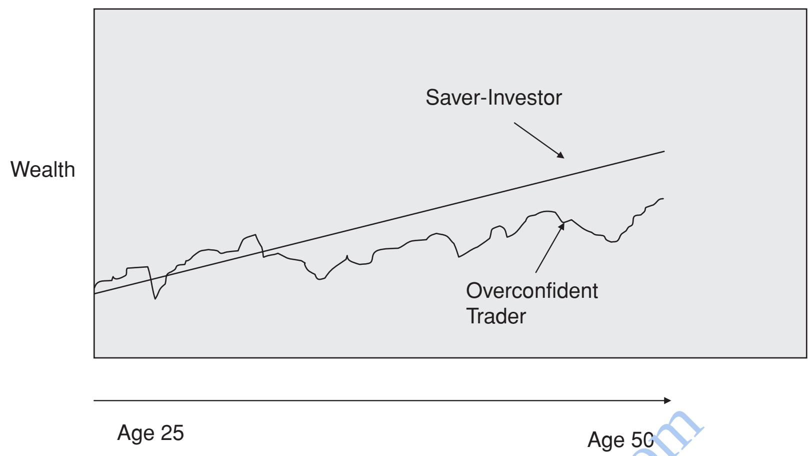

FIGURE 1.2 Saver-Investor versus the Overconfident Trader

causes even more of the gambling behaviors to kick in, so that they engage in the same risky trading behavior in an attempt to get back to even. This example is in contrast to the person who avoids such behavior (or keeps it to such a modest amount that it does not affect long-term wealth creation) and manages to save and invest over long periods of time to build wealth gradually. Notice a pattern here? This example is, of course, nearly identical to the yo-yo dieter in the nonfinancial examples who attempts to lose weight quickly on a regular basis only to gain it back. In this case it's the opposite situation: The person attempts to gain wealth quickly, only to "lose it back." Figure 1.2 illustrates the overconfident gambler versus the opposite type of investor, whom I will call the saver-investor. Both start at 25 years old and are currently 50 years old. Figure 1.2 extends out in time to show that there are still opportunities to change behavior even at mid-life.

Naturally, this chart does not represent reality perfectly, but you get the point: It's not hard to tell which kind of person you want to be. So, why can't we do it? The answer is that we can, but we first need to identify the key factors that are rendering us incapable of engaging in good behavior.

Number 3: The "Too Conservative" Investor

Although it is not as common, there exists a class of investors who are too conservative in their thinking. They are so afraid of losing money to a down stock market, whether through previous personal experience or not, that they simply won't accept any amount of risk. The failure with this approach is that people who cannot accept some amount of risk also risk outliving their money. The diagram in Figure 1.3 illustrates. Early into one's career,

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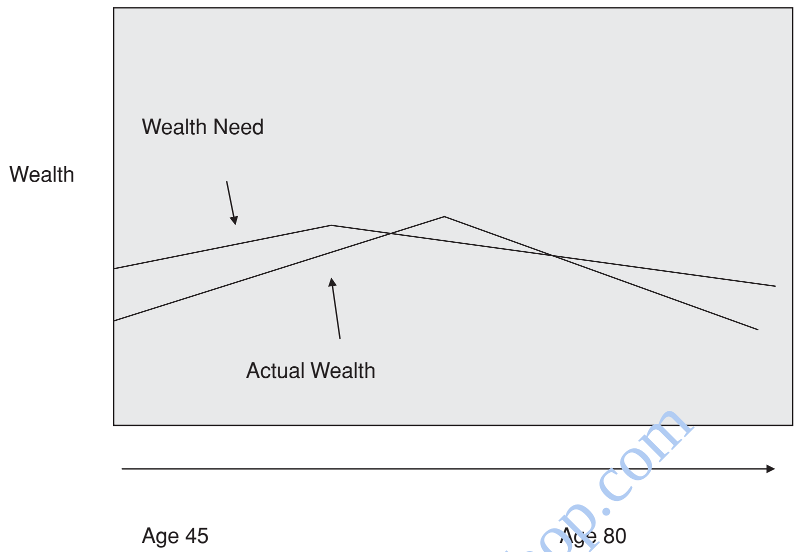

FIGURE 1.3 The Risk-Averse Investor

earning may not keep pace with the demand for funds due to expenses like college and housing. At some point during mid-career, these expenses may be surpassed by earnings and debt is reduced. Then later in life, one's working career can end either voluntarily or not, and cash needs should be surpassed by income. But if one does not accumulate enough of a nest egg and invest it wisely, there can be a situation where one may outlive one's assets. This is demonstrated in Figure 1.3. Certain people in this situation intuitively know that they need to increase risk, but they simply cannot take action to do it. They know about concepts such as inflation and low yields on bonds, but they will not take the risk this is necessary to build wealth.

Like the previous figure, this chart does not represent reality perfectly, but you get the point: You don't want to be in a situation where you don't have enough money as age increases. Taking risk in this case is advisable. In other cases advisors spend a good deal of time talking people out of taking risk.

We have reviewed three very basic situations in which we have identified a type of investor. The intent was not to go into great detail but to illustrate a situation in which it is difficult to control one's impulses toward a certain action or behavior. As we saw with the nonfinancial situations, people know they are taking actions that are not in their best interest. Similarly in the financial examples, we saw that people can make financial decisions that are not in their best interest even when they know they should take a different path. In many other cases, people may not be aware of their irrational behavior, and they need their advisors or other close relations to help them understand that they are making mistakes.

SUMMARY

The remainder of Part One is devoted to helping readers to (1) understand the history and the basic concepts behind behavioral finance—that is, rational versus irrational investor behavior; and (2) reviewing 20 of the most common behavioral biases advisors and investors come across when making financial decisions. Why is this important? It's important because this information will help readers to gain a foundation for understanding concepts presented later in the book; specifically, to identify what key behaviors are impeding advancement towards attaining financial goals. The mechanisms for identifying and managing unwelcome behaviors are presented in the book in the form of investor personality types or, as I call them, Behavioral Investor Types (also known as BITs.) If you can identify what basic type of investor you are, and then diagnose your unique irrational behaviors, you will be in a much better position to overcome these behaviors and, ultimately, reach your financial goals. If you are a financial advisor, and you understand the behaviors that lead to poor financial performance—either yours or your clients'—you will be well positioned to advise your clients to behave better. Figure 1.4 describes this idea in basic, yet I hope beneficial, terms.

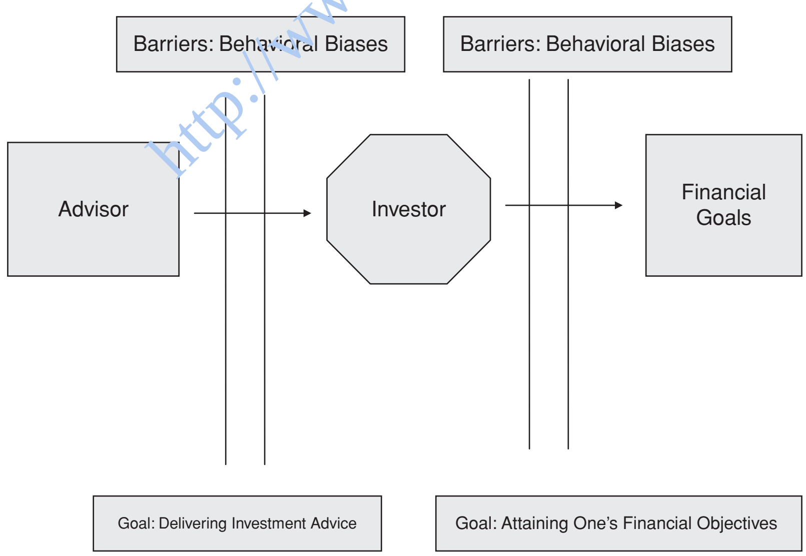

FIGURE 1.4 Barriers to Attaining Financial Goals

Now that we have examined self-defeating behavior examples, both financial and nonfinancial, we will move on to the rest of Part One by first examining the background of the study of investor psychology, or *behavioral finance,* in Chapter 2.

NOTES

1. "Top 10 Triggers for Over-Eating," Women Fitness—A Complete Online Guide to Achieve Healthy Weight Loss and Optimum Fitness (Fitness Women, Women's Fitness, Women Health, Woman Health, Health, Womensfitness), www.womenfitness.net/over-eating.htm (accessed July 5, 2011).
2. Annette Colby, "When Was the Last Time You Felt Fantastic?: Imagine Living Your Most Perfect Life and Feeling Better Than You Ever Thought Possible!" www.annettecolby.com (accessed July 5, 2011).