BOOK EXCERPT

WHEN LOGIC FAILS · INTRODUCTION

The Question I Brought Home from Chicago

Why the belief comes before the arithmetic — and what happens when the two collide.

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By the middle of 2010 I was tired. Financial advice had been tough and I had spent the better part of two years talking people out of decisions they were desperate to make. The financial crisis - the Global Financial Crisis, as we came to call it in Australia - had done what these events always do: it had turned careful people into frightened ones, and frightened people want, above all, to act. A great many of my working days in that period were spent on the phone or across the desk doing the least glamorous and most important thing an adviser ever does, which is persuading someone not to do something. In this case it was to sell everything at the bottom.

Most of them held on. Their plans survived and over time, so did their savings and investments. I am still proud of that. But it took something out of me, and when the worst had passed I found I wanted to understand what I had just lived through — not the markets, which I understood well enough, but the people. Why some could be steadied and some could not. Why the same facts, delivered the same way, could calm one person and terrify the next.

So I did something a little out of character. I booked a flight to Chicago, to a conference on behavioural finance - a field I knew existed but had never seriously studied; where I did not know a single soul.

I expected to spend the breaks alone, quietly sipping a coffee in a corner during the breaks. Instead, to my considerable surprise, I found myself to be rather popular. People kept drifting over to talk. I am not too proud to admit that I put this down, at first, to some natural charm I had apparently been underrating in myself for years. The truth, which took me an embarrassing day or so to work out, was less flattering. It was the accent. I was the Australian — and the Australians, just then, were of enormous interest to a room full of behavioural economists.

Here is why. While the financial world had been folding in on itself - banks failing, markets halving, house prices across America and Europe falling off a cliff - one housing market had barely paused. Ours. Australia was one of the very few developed countries to come through the crisis without a technical recession at all, and our property market, far from correcting, had picked itself up almost at once and carried on climbing, as it had for years: faster than wages, faster than seemed reasonable, faster than any logical or reasonable model of value could explain.

To the many behavioural economists at that conference (and probably to many classical economists also!) this was fascinating, and slightly scandalous. Recessions are supposed to be the market's way of correcting its own excesses — the moment when things that have grown too expensive are dragged back towards what they are actually worth. Australian housing had been handed the perfect opportunity to correct and had simply declined to take it. Person after person at that conference asked me the same question, in the same faintly baffled tone: why on earth do Australians pay so much for houses?

I did not have a good answer. But the question landed on something I had been half-noticing for years without quite looking at it directly. I had sat across from many would-be clients over the previous decade who were willing to pay far more for a house than any sober calculation could justify. I found that they were happy to stretch themselves to the edge, and past it, and compromise the whole rest of their financial lives. For a single property that had no reasonable method of actual valuation. They who did it with a certainty no spreadsheet of mine could dent. Borrowing so much to buy a home that they could not afford the life insurance to protect the family who lived there. It seems a bit like buying a car but not being able to afford petrol. At the time I had filed this under the ordinary human capacity for making a mess of things. Chicago made me realise it was not ordinary at all. It was a pattern, it was national in scale, and this was the forum that had noticed it before I had.

The conference had a ready vocabulary for it. Behavioural Finance had by then assembled an impressive catalogue of the ways human beings go wrong with money - a whole menagerie of biases, each with a name, each carefully documented. And they were real; you will meet a few of the more useful ones in this book. But the longer I sat with the question, the more I came to feel that the biases were describing might be described as the weather rather than the climate. In other words, focusing on the immediate short term rather than considering the longer-term consequences.

I devoured the dominant and hugely popular book ‘Thinking Fast and Slow’ as a great starting place to try to better understand people’s financial behaviours. It satisfied me initially as it provided a great sample of the many facets of human behaviour, but I couldn’t help feeling that there was something missing.

Behavioural finance told me how people went wrong. They did not tell me why - why property, why here, why with such conviction. Underneath the biases, doing the real work, was something the models did not have a column for.

It was belief.

Not opinion, not preference - belief. The deep, often unspoken, frequently inherited conviction about how the world of money works: that property is safe and shares are gambling, that the past is a reliable guide, that what worked for your parents will work for you. People were not first weighing the evidence and then arriving at these convictions. They arrived at the convictions first, and then arranged the evidence to fit. The belief came before the mathematics - and when the two collided, it was almost always the arithmetic that gave way.

That realisation set the course of the next decade of my working life. I went back and did the thing that had run parallel to most of my career: I studied it properly. I undertook a doctorate, and eventually ran the research you will meet later in these pages — including the finding that more than half of us cannot correctly recall which of our own investments did best. But the seed of all of it was that slightly absurd week in Chicago, being interrogated about the Australian property market by a room of people who found my accent more interesting than my opinions.

I have told you that story for a reason, and it is not only to explain how I came to write this book. It is because the thing I noticed in others is almost certainly true of you.

You have beliefs about money you have never examined - most of us do - and they are quietly running decisions you think you are making on the merits. They shape what you buy and what you avoid, what you call safe and what you call risky, what you remember about your own past and what you conveniently forget. They do this whether or not you can name them, and mostly you cannot, because a belief you can see is a belief you can question, and these have survived precisely by staying out of sight.

This book is an attempt to bring them into the light. Not to lecture you out of them - that does not work, and I gave up attempting it years ago - but to show you how they operate, using what I have seen across three decades of sitting with people at exactly the moments when money stops being a matter of arithmetic and becomes a matter of feeling. Some of what follows may be uncomfortable, in the way that catching sight of yourself in a shop window pulling an unguarded face is uncomfortable. That is rather the point. You can do very little about a belief you refuse to look at. You can do a great deal about one you have finally seen clearly.

Together, we will work through the narratives and stories that pre-form our decisions and start to understand that even the words and grammar we use influence these decisions. I will help you understand that one of the big problems we need to work through is the tendency to arrive at the answer and then look for evidence (often in all the wrong places) to justify it.

We see losses very differently to gains, and this applies even to money we really haven't lost at all. This feeling of loss can create the perfect conditions to lead us to financial destruction if we can't see it. I will demonstrate to you how we inherit many of these beliefs without realising it and how this can cause us to avoid what is often the most logical and best outcome.

I will introduce you to the 'fantasy factory' where we mistakenly see the world that was as the world that is and then get very disappointed when the outcome is not what we expected. Even worse, it can lead us down a path that means we are actively working against our best interests.

Then we change tack a little to start to discuss what we mean by risk, and that it is not at all what is measured in the world of finance. Safe doesn't really mean safe unless you know the difference between risk and uncertainty!

That's when we take a turn towards my research and how we mis-remember money. We don't seem very good at being able to accurately review our own investments and this can lead to mis-filing our past winners and losers. This leads us to building a virtual past which can produce whatever history we need to support our decisions. On the other hand, we have much less trouble when considering expectations for the future. I call this the re-constructed past and the calibrated future. It leads us to choose investments that we will actually say will under-perform because of our belief that they performed best in the past – even if they didn't!

We then move towards how gullible we are to someone who switches a safe investment to a risky one with the choice of word or imagery, and how to avoid it. By understanding how we can be manipulated we might be able to skip many of the scams and rip-offs we hear about almost weekly.

Which will lead us to the importance of an independent voice to support significant financial decisions. How to find someone to trust, and how to avoid someone we shouldn't. Beliefs and biases are so ingrained in our thinking that we simply cannot avoid them on our own.

And finally, we will increase our awareness of one of the biggest mistakes we can make financially. Thinking that investments become safer the higher the returns experienced.

That is what this book is for. Let me show you what I mean.

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