The Most Important Money Lesson

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A google query:

If you google "The Most Important Money Lesson", it will return with 61,800,000 entries.

A simple mathematical question?

This happened a while ago. I was asked this question, which I first thought was a quiz "Will you rather put your $1000 in a fixed deposit for 20 years earning 5% p.a. which can only be withdrawn at maturity? Or in another deposit account which can earn 8% p.a. for which you can withdraw at will at any time?"

I just started working at that time. I bought the insurance policy from him, my first, not because I gave the wrong answer but it was the mathematically correct answer in the wrong context.

It was a ***behavioral finance question***.

Behavioral finance – a story about Paulz

All of us are prone to behaving in a certain way when it comes to financial matters, and collectively we affect, shape and form the market.

There is always the temptation to make an investment, either in stocks, bonds or other asset classes with the aim of earning a return above the risk free rate.

Consider Paulz, who just read positive coverage in online investment forum about a newly listed biotech company Breakthrough Inc. He went on to gather some sketchy financial information and promptly made an EPS forecast of $2.00 two years from now, and on that basis made his $10,000 investment in the US market. Paul is ***overconfident of the precision or importance of the information he has to make a decision.***

When one is overconfident, a few things happen. He thinks the information he has is better than average. He thinks he is ***better able to interpret the information*** than the average investors. He naturally ***believes in his forecasting*** ability. He tends to be a good friend of the broker as he ***trades frequently since he believes he can time the market***. The resulting high trading costs offset any gains (if at all) that he has, as he sells stocks that continue to perform well (after he sells them) and replenish them with stocks that underperform.

Paulz was good by all accounts. He had the golden touch. Every investment was a run-away winner. In the run-up to the 2001 bubble peak, he accumulated an investment capital of US$300,000, on initial capital of slightly over US$100,000 - with the help of margin trading lines. As he was on his winning streak, he became bolder in his choice of investments. He felt that the US$200,000 paper gain was ***House Money***, which he could afford to lose. Of course, he was confident that would not happen.

The proverbial tide turned. What happened when Paulz started to lose money in 2001? As the stock prices started to decline, he ***devised a strategy – averaging down – with a goal to break even.*** Based on his analysis, he did not believe the market could continue to head south, and the online reports he read reinforced his view that the market and the stocks he bought will rebound. For Breakthrough Inc alone, he went into the market a total of 8 times after the initial $10,000 investment, averaging them from a stock price of $33.60 to $0.95, before the stock was suspended. He put in a total of $43,550, with brokerage.

By 2002, Paulz was completely wiped out. Not by the market (because he could have run with ample profits), but by his inability to control his behavior, by ***greed***, by his ***lack of discipline*** to cut loss, lack of will power to pull back – not unlike a compulsive gambler sucked into the biggest casino on earth.

It was back to 9 to 5. Paulz was a completely changed man. Whatever he had, he literally kept it under the mattress. Even as some sound investment opportunities came along, he passed. He is suffering from ***Snake Bite***.

The last we heard of him is that he had begun to nimble in the market again, when the STI crossed 2500 for the 1st time in 6 years….as the saying goes, ***time cures everything***.

Another million dollar question

We return to the same question: “Will you rather put your $1000 in a fixed deposit for 20 years earning 5% p.a. which can only be withdrawn at maturity? Or in another deposit account which can earn 8% p.a. for which you can withdraw at will at any time?”

Here is another “Will you buy a whole life insurance. Or go for a term insurance and invest the difference yourself?”

It is little realized that entirely different sub-industries have been built on the ‘answers’ (there is no right answer!) to or a debate on the above simple questions.

The Answer?

Having heard Paulz’ story and many of the common behavioral biases and weaknesses of investors in general, we have to wonder how anyone can answer those questions too convincingly.

The writer is a Senior Vice President at a Singapore bank and a certified Financial Risk Manager, with previous experiences developing strategies for retail banking and e-business. The article is contributed in his personal capacity.