The Behavior Gap: Pamela Yellen Interviews Carl Richards

Pamela: This is Pamela Yellen, President of Bank On Yourself, and I'm thrilled to be speaking today with Carl Richards. I know you're going to get immense value from this interview. Carl is a Certified Financial Planner who noticed over the years that the actual real life return the average investor gets is *dramatically* lower than the return of the average mutual fund.

Carl named this phenomenon "The Behavior Gap™" and began devoting his energy to exploring why the behavior gap exists, what constitutes smart investor behavior, as well as the importance of the connection between money and your values.

Carl writes a weekly essay for *The New York Times*, "Your Money" section, and makes a regular appearance on NPRs Marketplace Money. Carl also has a wicked way with a sharpie pen and his witty and insightful sketches have appeared in numerous publications, including the "New York Times", "Wall Street Journal", "Financial Planning" magazine and "Morningstar". Carl is the author of a book on The Behavior Gap that is coming out in January 2012.

Carl, welcome, and thanks so much for joining us today.

Carl: Thank you Pamela. I'm glad to be here.

Pamela: Carl, studying investor behavior has been a passion of mine for years, and it's not just individual investors who consistently underperform the overall market. The experts do it too.

Studies that I've seen show that 80% of all actively managed mutual funds and 80% of all investment advisory services underperform as well, and many do so with considerably more risk and volatility. So, can you talk about why this happens?

Carl: That's a relatively simple question with a fairly complex answer, so let me see if I can boil this down to something that makes sense. The reason it's so complex for so many of us is it seems to be totally counterintuitive with the way we think about everything else we do in life.

So let's just assume you're sort of the standard investor. We've got some money. Maybe it's in our 401(k). Maybe it's in our IRA. Maybe it's an inheritance, or maybe it's just some money we've saved up, and at some point, we have to determine how to invest it.

And what we've been trained to think is that we should go out and find some "expert" in the form of a mutual fund manager or an investment manger. So we set out on this process of trying to find an "expert", a mutual fund that will do well.

So the normal process for hiring somebody to do something for you it's normal, Pamela, to review somebody's past work history. If you were hiring an employee, you would review their resume and you would call references.

Pamela: Correct.

Carl: Let's say your college needs a new basketball coach. Like the University of Utah recently had to hire a new basketball coach. It would make sense to go out and look at candidates with a winning track record, and it would be reasonable, frankly, to expect that to continue. If somebody has done well in the past, you can expect it to continue.

If you're going to remodel your kitchen, it would make sense to go look at the work that the contractor you're about to hire has done in the past, and it would be reasonable to expect them to do similar work in the future.

Pamela: Correct.

Carl: And so we, when we're applying that same thinking to choosing an investment manager, we tend to go look at what's gone on in the past, and that leads us to this very, unfortunately, this doesn't work that way.

Because the market is a, let's refer it to the "zero sum game." If you think about that, for every winner, there's a loser. If I think GE is going to $100 and am willing to buy it, somebody out there thinks that GE is going to $2 because they're willing to sell it to me.

But one of us is wrong, and the problem is, the average mutual fund is going to get the average return minus their expenses, which is how you get to this 80% number. I'm not exactly sure what the number is; 80% sounds like numbers I've heard before. I'm sure it's in the ballpark.

So on average the average mutual fund ends up making the average minus their expenses, which means they do poorly. And then the other dilemma we have, of course, is it's really hard to identify luck from skill. You know with a contractor we can go look at the work and it's reasonable to expect that that's skill, and it will continue.

With an investment manager we really don't know if it was luck or skill, and we don't have enough history to determine that. *I mean it would take 20 plus years of history, probably more like 30 years of history to determine if there was skill there, and even then we would be identifying it after it did happen.*

So using that same idea of how do you pick a contractor, apply that to mutual funds or investments, will tend to result in buying investments that have recently done well and are therefore statistically likely to do poorly in the future; and I call that buying high. And then the inevitable happens.

Pamela: Yep.

Carl: A couple years later they do poorly and we say, "Gosh, we've got to fire that person." And then we're selling low, and that's the opposite of what my mom taught me about investing. I *thought* we were supposed to buy low and sell high.

Pamela: Absolutely. On Bloomberg.com recently there was an article where a well-known investment analyst was being interviewed about why he believes the stock market rally still has legs *in spite of* a nearly 100% rise off the market lows.

The reason he gave was that the people who had missed out on the 100% rally were getting in and would propel the market higher. It reminded me of the saying that if you're sitting at a poker table and you can't figure out who the mark is, it's *you*.

So Carl, why don't most people ever figure this out?

Carl: It's a fantastic question. I don't know if the analyst on Bloomberg is even close to correct or not, but this idea, and often you hear it referred to as, it's a really frustrating term for most of us, but you will hear it referred to as the "dumb money".

I actually wrote an essay at the time like "Are You the Dumb Money?" was the title of the book. March of 2009 we thought the world was coming to an end, and it was very, I mean it's easy now in hindsight to look back and say that was silly, but no *at the time*, it was terrifying. Legitimately you're like I have to stop this pain. And it's just a genetic trait, right?

Pamela: Yes.

Carl: If we *weren't* trained to get away from danger, we would have been eaten by saber tooth tigers a long time ago.

Pamela: Good point. It's a human reflex to protect ourselves.

Carl: Yeah, it's genetic. It doesn't matter how irrational it is. If I have my hand on a stove and it's hot, I'm going to take it off and so it doesn't matter what you tell me. Like hold on, hold on, hold on. It will get better. It will get better. If it's causing me pain, I'm going to try and get away from it.

The majority of people even, sold in the downturn. I don't know if it was exactly in March or if it was in February, March, April; **we know the outflows out of the equity markets were at historic highs so people were selling**.

You're sitting on the sidelines and you're watching, you feel better for a minute, but now you're watching the market go up and up and up. I know a lot of people who said they were swearing of the… I will never end up in the stock market again.

Pamela: Right.

Carl: And so now you're sitting there saying, "I'll never invest, I'll never invest, I'll never invest. Oh my gosh! The market's up 50%. The market's up 80%. The market's up 100% from the point I sold". And then you reach this capitulation on the opposite side where you're like forget it. That was emotional. I can't stand it anymore. I'll add money... And that's what this analyst is referring to.

We tend to, in fact, I have friends that I refer to as my "bellwether". I know when *they're* about the sell we *must* be close to a bottom.

Pamela: Yeah.

Carl: And I can be my own bellwether too. I mean I make the same mistakes. When they're about to buy, we must be close to a top. So often you get Wall Street refers to this as, "Okay. The dumb money is reentering, which means we must be close to a top…"

Pamela: A "contrarian indicator".

Carl: Yeah, which means that we're just about to go down again.

Pamela: Right. And the contrarian indicator historically has been quite reliable. When the dumb money is in the market, you know that, when it's piling in, then you know it's about to reach a top. Yep. And vice versa at the bottom.

Carl: I think maybe to answer your question of why don't we ever figure this out, is it's hardwired. I mean it's so emotional and genetic that it's really hard for us to develop a plan and absolutely stick with it. I've almost determined that… the solution is to take the sharp power tools away. Managing your own emotional behavior as it relates to investing is really, really hard.

Pamela: Yeah, and I've basically come to the same conclusion watching people make the same mistakes over and over again. You at least were willing to admit you've done the same thing, and I've done the same thing, and I'm willing to admit it. It is hardwired in us.

One of the things you talk about is, what *does* constitute smart investor behavior? So in your experience, what are the keys to being a smart investor?

Carl: Yeah, I mean I think the first thing is to just stop for a minute and review your history, and luckily, we have bank statements or investment statements, bank statements and tax returns. It's a **factual** history.

So we can go back and review objectively. Pretend like, and if you can't do this on your own, hire somebody. I mean hire a CPA. Hire an attorney. Hire a good financial advisor.

But find somebody to objectively review because we tend to only remember the decisions… It's like the gambling problem and I've heard jokes like your brother-in-law is a liar. If all you ever hear is the great investments your brother-in-law made, they're not telling you the whole truth.

Pamela: Of course not. The big fish, the fish stories.

Carl: Yeah. Like a gambler doesn't talk about his losses. They only talk about their wins. **So the first thing to do is to stop and be really honest with yourself** and say, look, if you're making the same mistake, and luckily we've got a ten-year period here where it's a really good way to look at it.

I mean you can see what you did in 1999, 2000, 2001. If you were involved in the market, you can see… If you started buying again in 2006, 2007, if you borrowed against your home to invest in the stock market in 2007. If you decided you were going to become a real estate investor in 2007, right, which a lot of people did. And then if you sold in March of 2009, and now if you're feeling like buying again, just be honest.

Like wait a second. "I keep making the same mistake over and over and over". So that's the first step.

The second step is then put in a plan in place that will prevent that mistake, and there are obviously a couple ways to do that. The traditional way is to decide a specific percentage that goes to stocks and a specific percentage that goes to bonds and cash, and then **make that ironclad that you will rebalance back to that**.

So after a roaring bull market, if you started out 50/50, 50% in stocks, if the market has gone up, it finds you maybe 60%. It's time to go back to 50/50. *That's really hard, but it's one way.* It's hard because it will force you to do the opposite of how you feel.

It forces you to sell things that have done really well and then we have a market downturn it will force you to buy things that have done really poorly, but that's one way.

The other way is, **I don't think there's anything wrong with admitting that you just shouldn't invest in the equity markets. It does not make you stupid**. It does not make you anti-American. It does not make you dumb to decide hey, you know what? **I'm just better off never losing money, and I should buy CDs the rest of my life or I should find some other instrument that just allows me to never lose money.**

Because I can tell you if you go through your whole life and you never lose money, you'll probably do better than 80% of the people you know.

Pamela: Carl, that's such a great point because that is the reality. The reality is that yes, maybe over the long-term the equity markets do show excellent returns, but because we are humans and we're hardwired, as you have often said, to buy and sell at the wrong time, **it doesn't really matter what you *could* do in the overall market.**

So it really does come down, like you say, to understanding *who* you really are and how you react. And if you… I love the advice. Actually go back and look at the statements. Look at when you were buying, when you were selling, and maybe you just need to admit to yourself you're not cut out to be in the equity markets.

I saw an article that you had written for the "New York Times" and you suggested that people should consider whether they should even be investing in the market at all.

It's interesting because that is advice you will not see very often, so I appreciate your giving some parameters for how people can determine if they are the kind of person that should be in or not.

Carl: We've all been trained to believe that getting to your financial goals is a function of getting the highest return.

Therefore you should be focused on finding the best investment, but really there are other things that are in, that's not in our control. That's only *one* lever in the equation. *The other lever, of course, is I could save a little bit more. I could devote that time that I'm spending watching CNBC to doing a side business, and I could make a little bit more. I could adjust my goals in the future so that my savings will meet those goals.*

I think balancing your ability to make money may be the most valuable asset you have. Your income may be the most valuable asset you have, and figuring out how to take that asset and set some of it aside.

I saw this survey where, I can't remember what the number was, but it was a pretty high number that *most* of the money in 401(k)s was the result of *putting money into* 401(k)s.

Pamela: I've seen those studies, and that's absolutely true, and in some cases **there would be no gain at all if it hadn't been for the employer match.**

Carl: Right, right. The money you have in your 401(k)…

Pamela: You put it there.

Carl: Like housing. You'll hear people and they're sort of in their 70's or 80's make this statement a lot that their house was their best investment they ever made, and I've been really curious about this. So I went back and looked.

If you've been in your house 30 years, if you calculated your rate of return, your internal rate of return, all the money you put into the house; I'll bet you're about zero.

Pamela: The long-term studies by Shiller, who has the Case-Shiller index, prove exactly that. It is actually less than, it's about ½% a year on an inflation-adjusted basis, and that's in spite of all the big upticks we've had and the downturns and so on. Most people were taught to believe that the equity in their home is going to provide a significant portion of their retirement slush fund, and it was based on incorrect historical information and the belief that somehow that was going to change I guess.

Carl: But I think maybe the point is, and you're right, that number is ½%, so it just barely outperformed inflation, *but that number was 2006 before the massive decline*.

Pamela: Right. And I really do love the distinction you made between focusing on… There are things you can't control - like you really can't control the rate of return you're going to get - and putting more focus on the things that you *can* control, like savings, revising your goals, perhaps going into business for yourself or a side business. Wonderful advice Carl. That was terrific.

Carl: Thank you.

Pamela: You also talk a lot about the relationship between money and happiness, and the studies that I've seen show that money *does* buy happiness, but *only* up to a point. And a big part of why so many Americans got into trouble during the financial collapse is they really got caught up in that whole keeping up with the Joneses syndrome.

But research shows that the thrill or pleasure you get from consuming stuff is fleeting. In your experience, what *does* tend to bring people more lasting happiness?

Carl: That's a great question, and it is true: Money does buy happiness up to a level. *It's basically a basic subsistence level*. You're clearly not happy if you can't buy bread. Well I shouldn't say that. It makes it challenging to be happy in an environment where you can't afford to feed your family.

But once we get past that, like just the basic necessities, then it's such a slippery slop because we have this tendency to think, you know, if I only had this. All the studies I've seen, **it's relationships and experience**. Experiences with people you love, things you love… I don't mean things. Having experiences with things you love in the sense of like maybe I really like to go mountain biking. Well doing that will bring me more happiness than buying another mountain bike.

Pamela: Great. Great point.

Carl: And I think spending time with my family - building those relationships are lasting happiness, and it's funny my kids don't know the difference between staying at the Ritz-Carlton…

I heard this story once that somebody said to their daughter, "I love you daughter." And she said, "I don't want you to love me. I want you to play catch with me."

Pamela: Yeah. People are so happy just being with people they love and that are friends and family and so on rather than what have you done for me lately? What have you bought for me lately? There is a certain adrenaline high that most people get when they do buy something, but it wears off very, very quickly.

If you look back at the things that you *did* buy that you thought gee, I *have* to have that. What an amazing difference that will make in my life if I have that. And you realize that the novelty of it, in most cases, you know, wore off pretty fast.

Carl: Yeah, and here's an experiment. I do this with Amazon, but you don't have to do it with Amazon. Have a 30-day hold list where you find something that you absolutely can buy, and in the past you would have just whipped out the credit card and bought it. It's something you have to have. You're just going to buy it. Well just try, and it doesn't even have to be 30 days. Try 7 days. Try 3 days.

Where you make a little spreadsheet or a little list. You can have it on a little piece of paper. Carry a 3" x 5" card. And before you use your credit card for anything that can wait at all. Unless it's… you're going to the grocery, sure, but I do it with books, because I buy a lot of books and so I was curious. I found myself buying a lot of books and then not reading them.

Pamela: 80% of all books that are purchased never get read.

Carl: Yeah, so I started adding them to my shopping cart at Amazon and saying you can't buy that until it's been in your shopping cart for 7 days. Guess what? I have like 200 books in my shopping cart. You know like 3 days, 7 days later I'm like you know what? I don't necessarily need to read that.

So yeah, I think you're right. Try it. Try a 7-day hold on every discretionary thing that your going to spend and see if 7 days later you still want it, and I think you'll be shocked at how much of that stuff you're just like, you know what, I don't want it anymore.

Pamela: That's a great suggestion. I've always thought of the 7-day rule, but you know what? I'm going to try the 30-day rule. I think that's an even better one. Good advice.

So do you have any suggestions for people for how they can stay more focused on what really matters to them and to be more resistant to being seduced by stuff and what other people are doing? I mean you just gave a great idea about how to avoid being seduced by "stuff", but how do you focus on the relationships and the experiences when you see everybody else is doing it?

Carl: There is a strong belief in society today that buying things and spending money brings happiness, and when you blend that with stress that we're all under the last couple of years, I think buying something is a safe way of getting a similar high that you could by using drugs.

Pamela: Yeah.

Carl: Right. By safe I just mean it's an acceptable way of blunting, of dealing with stress. Society is okay with you spending money to feel a little better, and it does. It does make you feel better sometimes.

This goes back to the same question about whether you should be in the equity markets or not. **I like to call it radical self-awareness.** It starts by really taking the time to start having discussions with your spouse, your family, and your friends.

Like what is it that ***really*** *brings us happiness?* Like oh, we go on this trip and come home, and you have to say to yourself like was that really fun? Would it have been just as much fun to go 4 hours out of town and camp with the kids and play Frisbee?

Pamela: It will help anyone who is paying attention and is not looking for the magic pill. They have to understand that *it is a process.* It does take awareness, and it takes questioning yourself and questioning your past experiences and evaluating did that actually give me the satisfaction long-term that I thought it would, and is there something else we could have done that would have been more satisfying? Those are simple and very powerful suggestions.

Carl, you had mentioned to me before this interview that a financial advisor had brought my book "Bank On Yourself" to your attention about a year ago. You also mentioned you used to lump all the different types of life insurance together - whole life, universal, variable life together and kind of hammer on them all until an advisor sat you down and showed you what a Paid Up Additions Rider on a whole life policy is.

I've often pointed out how many financial advisors, even those who have all the alphabet soup after their names, really don't have a clue about this, and I've also said it's really not their fault because it's really not taught in the training advisors take to get their licenses or even to get the advanced designations.

I do commend you for at least being open-minded enough to learn more about it, but I'm curious because you're a Certified Financial Planner. You've got some of that alphabet soup after your own name. Why do you think there is so much resistance amongst both the financial gurus in general and the rank and file advisors to be open-minded?

Carl: I think there are two, at least two pieces to it. Number 1, specifically with it's not just life insurance and the appropriate use of whole life, for instance, that people are closed-minded about. It's *any* sort of new investment strategy or way of thinking.

A part of that is because the hardcore investment industry and even sort of the academic side of finance has really adopted this idea that this is sort of a science. Economics has done the same thing. Economists do the same thing. They assume, one of the core assumptions is that we're all rational actors, that we will all make the rational decision all the time and won't be influenced by behavior, fear and greed; and we just know that's not true.

Why would you ever put money in a CD, or why would you ever use a whole life cash value policy as an investment, if all you have to do is just be rational? That's sort of the argument.

But the reality is we're not, and it's not a science. So being open to the idea that it's not a science, suddenly introduces a lot of messiness. It's not as clean as physics. We really want, that term physics envy. We really want a nice simple model. But it's not clean. It's fuzzy and mushy and complex and hard to define. That's one reason.

The second reason I think, specific to the use of insurance - most life insurance agents I've run into don't even know how to use this properly. Both the agent and the life insurance company, it's not quite as profitable, but it takes a unique person to say, "Hey, I want to build an advice business for the long-haul, and this is a powerful tool, and I'm okay giving up a little bit of my commission upfront in exchange for making this client happy over the long-haul."

That takes a unique person, and it's not in your… Actually I think it is in your own self-interest as a life insurance agent. It is in your self-interest because you'll have a happy client, you'll end up making more money over the long haul because you won't have to keep hunting for new people…

Pamela: It's a longer term, yes, and then we get right back into people are immediate gratification focused. In the case of the typical Bank On Yourself Authorized Advisor - when they structure a policy this way, **they're going to cut their commissions by 50% to 75%, Carl**. That's not a little. *That's a lot.*

Carl: That's a lot.

Pamela: And the reason there are only 200 of them in the entire country after 8 years of searching is because so many of them are looking for that immediate, they hear that they're going to give that up, and they lose interest; but you are absolutely right.

The advisors have found that they have lifelong raving fans who happily refer everybody they can think of to them without being asked. I mean whereas the typical life insurance agent, most people would rather have a root canal without anesthesia than talk to one of them.

Carl: Right. Totally true.

Pamela: Carl, is there one last piece of advice you'd like to give our listeners who are trying to be in control of their money and finances *rather* than letting money control them?

Carl: It's just this idea of practicing radical self-awareness and being really honest with yourself, and *from my experience, I have found that for most of us the #1 priority should be not losing money*.

And then shift all that energy and stress that has been focused on finding the best investment. Shift that time and energy and stress to either enjoying, finding those things that will make you happy and enjoying your experiences with friends and family, and/or figuring out how to take that same amount of time, energy and stress you were spending trying to find the best investment, and redirect it, *trying to figure out how to save more.* Get creative there.

Or start this little side job. Earn a little bit more money so you can save a little bit more. So practice radical self-awareness, be honest with yourself about how you've done with your own investments and then maybe there you'll find the space to focus on one of these other levers, *meaning maybe you could save a little bit more or enjoy your life a little bit more.*

Pamela: Fantastic advice, Carl. I really appreciate and I know that our listeners will get a lot of value and very specific suggestions that can be very helpful to them if they apply them. So I thank you so much for sharing your research, insights and tips. I'm really looking forward to the publication of your book "Behavior Gap" in January 2012, and I'm hoping that you'll join us again when it's published.

In the meantime, I encourage people to check out your website: BehaviorGap.com, where they can receive a new sketch from you every week along with helpful advice and information. That website again is BehaviorGap.com.

Carl thanks again so much. I really appreciate you sharing what you have today.

Carl: My pleasure Pamela. It was a lot of fun.

© 2011 Hayward-Yellen 100 Ltd Partnership