Financial Fables

Ely Prudent Portfolios

Being Human

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I have only used an ATM machine three times in my life, never without help, and, oddly, never in the same country. For some reason, I have a phobia about engaging in financial transactions with machines. That's why I was so nervous recently about an upcoming trip. I had to go to San Francisco, which meant either sitting in that bottle neck known as the Bay Bridge, or parking in the East Bay and taking BART into the City. BART is faster, cheaper, and easier - but it involves interacting with a vending-style machine for purchasing tickets, and another for paying and verifying parking.

Standing in front of the big monolithic ticket machine, I feel like Dave Bowman in 2001: A Space Odyssey, completely at the mercy of the rebellious computer, HAL. I politely say, "Hello, [BART]. Do you read me?" The machine answers, "Affirmative, [Guerdon]. I read you." I ask for a ticket but instead get, "I'm sorry, [Guerdon]. I'm afraid I can't do that." I protest, "What's the problem?" The machine scoffs, "I think you know what the problem is just as well as I do." Well, if I knew what the problem was, I wouldn't be having a schizophrenic conversation with this stupid machine. Knowing it is an argument I will never win, I do what I always do and ask some nice person to buy a ticket for me.

According to Jason Zweig in Your Money and Your Brain, my fear "…does not make logical sense but [it does] make perfect emotional sense. That does not make [me] irrational. It makes [me] human." He explains that investors similarly make illogical decisions because "emotional circuits deep in our brains make us instinctively crave whatever feels likely to be rewarding and shun whatever seems liable to be risky." And these emotions are so strong that they often overwhelm the analytical circuitry of our brains. "That's why knowing the right answer, and doing the right thing, are very different."

Answers and actions are different, Zweig says, because investors cannot be completely rational when dealing with risk. "Our intuitive sense of risk is driven up or down by what Paul Slovic calls 'dread and knowability' [which]… infuse risk with feelings." Therefore, we fear market risk because it is potentially catastrophic (dread) and highly unpredictable (knowability). The recent financial crisis has only made investors more fearful of stock market risk, causing them to flock to the seeming safety of government bonds and other alternatives, such as gold. But John Bogle, the founder of Vanguard Funds, points out in a recent New York Times (8/13/12) article that, in spite of these fears, "It's urgent that people wake up… because risky as the market may be, it is still likely to produce better returns than the alternatives."

That's why Bogle implores investors to "stay the course." However, while our analytical brain knows that long-term success depends on staying the course, our emotional brain wants to cut and run. Maybe in some future Aldous Huxley type Brave New World, our descendants will have genetically and pharmaceutically altered brains that don't infuse risk with feelings. But until that time comes, we need to realize that the tensions within our brains cause us to be terrible assessors of financial risk.

I will never be comfortable using BART ticket machines, and you will never be comfortable with market volatility; it's just the way our brains are wired. But riding BART is the most efficient and effective way to get to downtown San Francisco, and stocks are the most efficient and effective way to grow a well-diversified portfolio that includes bonds and other fixed-income investments. So, the next time the market drops and you want to cut and run, consider HAL's advice, "I can see you're really upset about this. I honestly think you ought to sit down calmly, take a stress pill, and think things over." If that doesn't work, you might try asking some nice financial advisor to manage your portfolio.

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