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The Smarter Investor

Riding the Elephant: Mastering Decision-Making In Money And Life

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The most compelling findings regarding financial decision-making are found not in spreadsheets, but in science. A blend of psychology, biology and economics, much of the research on this topic has been around for years. Its application in mainstream personal finance, however, is barely evident. Perhaps a simple analogy will help you begin employing this wisdom in money and life: The Rider and the Elephant.

First, a little background.

Systems 1 and 2

Daniel Kahneman's tour de force, Thinking, Fast and Slow, leveraged his decades of research with Amos Tversky into practical insight. Most notably, it introduced the broader world to "System 1" and "System 2," two processors within our brains that send and receive information quite differently.

System 1 is "fast, intuitive, and emotional" while System 2 is "slower, more deliberative, and more logical." The big punch line is that even though we'd prefer to make important financial decisions with the more rational System 2, System 1 is more often the proverbial decider.

Many other authors have built compelling insights on this scientific foundation. They offer alternative angles and analogies, but I believe the most comprehendible comes from Jonathan Haidt.

The Rider and the Elephant

The author of The Happiness Hypothesis and a professor at New York University's Stern School of Business, Haidt describes the two systems in a helpfully visual way:

The mind is divided in many ways, but the division that really matters is between conscious/reasoned processes and automatic/implicit processes. These two parts are like a rider on the back of an elephant. The rider's inability to control the elephant by force explains many puzzles about our mental life, particularly why we have such trouble with weakness of will. Learning how to train the elephant is the secret of self-improvement."

Do you see the connection? System 1, in this case, is the Elephant. It's instinctive, powerful and predictably emotional. System 2 is the Rider. It's the rational thinker, capable of deconstructing complex problems but incapable of overpowering the Elephant.

How, then, do we, as Haidt suggests, train the Elephant?

Elephant Training

First, recognize that the Elephant—emotion—is not the problem. Indeed, it may be part of the solution. Too many in the realm of personal finance have labeled emotion as the enemy. They tell consumers that investing, in particular, is best practiced by ignoring or suppressing emotions. But this is shortsighted.

Let's say an investor is coached that the market goes up and down, but ultimately, a willingness to stay invested in stocks will net the best long-term returns. Therefore, one's portfolio would be optimally invested wholly (or mostly) in equities. Well, suppressing one's emotions regarding the fear of deep market losses might help an investor stick with their financial plan in a mild correction, but in the early 2000s and again in 2008, many an Elephant reared up and sent the rider on a precipitous fall of his or her own.

No, optimal portfolio construction involves inviting the Elephant into the boardroom to have a say. Emotions should not be ignored, but rather

The Secret to Making Good Decisions

Deepak Chopra is a doctor, a noted author who has written more than 20 New York Times best-sellers, and a renowned public speaker. The Chopra Foundation is described on his website as being "dedicated to improving health and well-being, cultivating spiritual knowledge, expanding consciousness, and promoting world peace." Its mission is to "advance the cause of mind/body spiritual healing, education, and research."

Chopra writes in one of his blogs that when decision-making is studied, not enough weight is given to the human element that is involved in the process. He looks at the four human elements that help make a decision a good one: emotions, self, vision and surroundings

To read the blog please visit this link: https://www.deepakchopra.com/blog/article/4592

Overcoming Paralysis by Analysis

"In any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing and the worst thing you can do is nothing." --Theodore Roosevelt

Paralysis by analysis is the result of too much thinking causing too little action. Doing nothing can be the easiest course of action, especially with the overload of information available today.

Forbes offers some things to consider when you are feeling inundated with information.

To view the Forbes article please visit this link: http://www.forbes.com/forbes/welcome/#113563807cc44bc438da7cc4

acknowledged and accounted for in the creation of an ideal investment portfolio. Practically speaking, this means that many people with equity-heavy investements—at any age—should listen to the Elephant and seriously consider increasing their exposure to a portfolio's stabilizing force: conservative fixed income. It's also important to recognize at this point that most households have two Riders and two Elephants, each of which needs to be heard.

The Rider and Elephant work best as a team. While this is readily apparent in most areas of investing, it becomes especially clear in decisions involving the prospect of death or disability. Statistically speaking, when it comes to writing estate planning documents and planning for death or disability with insurance, the collective Elephant has simply run for the hills, ignoring this possibility altogether. But the Rider can coach the Elephant very effectively:

Rider: "We need to talk about our will."

Elephant: "Death? Ooh, no. I'm not going there."

Rider: "I understand. It's not exactly fun to consider, but what scares me even more is what could happen if we don't consider it at all."

Elephant: "Yeah, I guess I hadn't thought about it that way."

Rider: "Like, wouldn't we rather decide who would take over our role as parent if we were gone, rather than entrust that important decision to the state?"

Elephant: "Yep, let's schedule that appointment."

Every great team has to practice in order to work together effectively, so try imagining the implications of your neuro-duo in any number of circumstances, from budgeting, insurance and allocating your 401(k) plan to even more important stuff, such as career, marriage and child-rearing. Through persistent practice, it's even possible to transfer the once-complex tasks undertaken by the Rider to newly instinctive responses by the Elephant.

From the Sharpie of Carl Richards

Life is full of decisions. There are ho-hum, everyday ones (bagel vs. oatmeal, what color shirt to wear). There are larger, wider-scope ones (how to spend our most precious resources -- time and, of course, money). When it comes to those financial decisions, Carl Richards, director of investor education for the BAM ALLIANCE, says, "The single most important thing you can do when it comes to making good decisions with money is to get clear why you are doing it. ... Why are you doing the things you do with money? Take the time to have a discussion about your values so you can be clear about why you are doing the things you are doing."

Why. Why? Why?!

The way we go about approaching and making decisions, financial and otherwise, is a common, foundational theme in the messages shared by Richards, through his writing and in episodes of his Behavior Gap Radio.

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