TMA Book Review:

Psychology of Money by Morgan Housel

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Marcelo: Welcome to The Empowered Investor Podcast. Today I'm joined by my two co-hosts, Jackson Matthews and Lawrence Greenberg. Jackson, you've been an advisor for about three years. You got your CIM, you've been working with clients, and it's your first time on the podcast. How do you feel?

Jackson: I feel very excited. For the last two and a half years or so, I've been on the back end of the podcast doing the research, preparing the skeleton for the podcast, and then editing it after the fact. So I'm very excited to be on the forefront this time.

Marcelo: Well, I tell you, you've been instrumental in ensuring that we have good notes for the episodes, good skeletons, and I'm sure it's made you a better advisor because you have to be on your toes and keep doing research. I mean, I did that a bit at the beginning, and it did help me a lot. So Lawrence, it's not your first time. You've been doing the podcast for like five, six times now, so I'm sure you're excited to be here.

Lawrence: Always happy to be here.

Marcelo: Perfect, perfect. Otherwise, I'll have to kick you out of the show. Okay, so we're going to do a very special book today. This book has taken the financial industry and the book industry at large by surprise and like a storm. It's *The Psychology of Money* by Morgan Housel. Guys, I can't think of a person that I've suggested the book to who hasn't loved it. So tell me, what are your general impressions of the book? What did you love about it, and why are we doing this episode today?

Jackson: I really liked the book. I read it twice in preparation for this podcast.

Marcelo: Twice?

Jackson: Well, I read it for the second time in preparation

Marcelo: I'm impressed.

Jackson: It definitely won't be the last time I'll reread it over my lifetime. I really like the book because it's filled with stories and anecdotes of money stories and how different people think about money differently. It makes you think about money differently in ways that you probably wouldn't unless you were reading the stories and were prompted about it.

Marcelo: A hundred percent.

Lawrence: What I'll say is, I love this book. I think it's great for any person with any financial background, regardless of your knowledge. It's exceptional. I've read a lot of financial books out there, but this one is really good at storytelling, making these things very digestible and easy to understand. He uses storytelling extremely well. It's a must-read. It's a five-hour read, and you'll be better for it.

Marcelo: There's a lot in the book. It packs a lot of punch for the amount of pages that it has. So we can't do it justice in 30 minutes. We've distilled and broken down what we think are the most important points in regard to our clients and listeners. We're going to break down the sections and have a takeaway per section with actionable items. There's a really good quote in the book that I think encapsulates its essence: "Your personal experiences with money make up maybe 0.0001% of what's happened in the world, but maybe 80% of how you think the world works." This is the best segue for the first section we're going to talk about, which is the role of emotions in investing. Emotions are very important. Jackson, break that down for me. What are the main emotions and pitfalls when it comes to emotions and portfolios? And throw in some examples from the book.

Jackson: The role of emotions in investing is a huge part of finance. That's why Morgan spends so much time breaking it down in the book. I think emotions are probably the single biggest force that stands between an investor and a purely successful investment journey. They cause you to make investment decisions that are probably not the most optimal and sometimes it may pay off, but other times it may really put your portfolio's success at risk.

Marcelo: So give me some examples of what pitfalls people can fall for.

Jackson: There are so many mental biases, but just to name one, loss aversion, for example. It's when an investor will hang onto a losing stock that has an unrealized loss and they refuse to sell it because they want to see it come back up, even though the prospects of that investment might be poor.

Marcelo: So you bought Peloton, it totally went down, and you're attached to it, you don't want to sell it. That's loss aversion.

Jackson: Exactly. You refuse to sell it because you want to see it go back up.

Marcelo: Interesting. Okay, what about an example from the book?

Jackson: Morgan has an excellent example about a janitor named Ronald Reed. This janitor had a very simple lifestyle and a modest income. He controlled what he could, saved what he could over his lifetime, and watched how much he spent. He monitored his emotions and let the markets do their magic. After 40 years, his family was pleasantly surprised to find he had amassed $8 million in his estate. People were shocked that this janitor had a net worth of $8 million by the end of his life. He did what most people cannot do—keep their emotions in check and let the magic of compounding work.

Marcelo: Wow, that is a crazy story. Think about all the things that happen over 40-50 years—recessions, wars, bad events like 9/11 a lot of things that put fear into people's minds. It's remarkable.

Lawrence: The big takeaway here is how shocked his family and friends were. They had no idea he had that much money because he lived within his means, a very modest person. He understood that spending is the enemy of wealth.

Marcelo: Absolutely. There's another example about the odds of the stock market. Tell me more about that.

Jackson: This really talks about lengthening your time horizon to give you more success in the markets. The more you can control your investment behavior and emotions, the more likely you'll succeed. Historically, the odds that the US markets will go up are 50% over a one-day period. The more you lengthen the time horizon, the more the markets are likely to go up. Over a one-year period, it's 68%, over a 10-year period it's 88%, and over 20 years, it has gone up 100% of the time. This speaks to the fact that if you can do a good job at managing your investor emotions over the long term, you're more likely to succeed.

Lawrence: Investing is a game of probabilities. There are no certainties. These stats are for a broad market, not any individual security or investment.

Marcelo: I was just going to ask that.

Lawrence: Exactly. This is a diversified pool of stocks. It's all about probabilities. Anyone who promises what will happen in the future—I'd put it at 50-50.

Marcelo: Of course, it's a coin flip. So what's the takeaway from that section, Jackson?

Jackson: The takeaway is to have an investment philosophy and follow it. This is a guiding set of principles that help you make investment decisions when times are tough. When there's a recession or market correction and your emotions are extremely high, your guiding set of principles will allow you to make rational decisions.

Marcelo: Very well put. Let's move to the next section, which is the role of adaptability and flexibility. What's rational versus what's reasonable?

Lawrence: This is really important. The nature of finance is about numbers, quantitative things, crunching numbers, spreadsheets, models, and all that stuff. But human beings are at the core of it. When we build financial plans or analyze the future, we have to understand each person's individual circumstances and personality. We have retirees who may be 80%, 90%, or 100% in stocks. They understand and can tolerate that. We have others who are more conservative. Your financial circumstances have to allow for these things, but the idea is that no one is the same. There's no one-size-fits-all in finance. It's extremely important to find the gap between what's perfectly rational and what's reasonable for each person.

Marcelo: You put a great example here. Let's go through it.

Lawrence: A common question we get now with higher rates is whether to pay off debt or invest in a diversified portfolio of stocks and bonds. When rates were low, the decision was easier. Now, with higher rates, it's more complex. Each person has a perfectly rational answer, but many have an aversion to debt and prioritize paying it off over investing. We have to understand individual circumstances. There's no problem in that, it's perfectly reasonable.

Marcelo: How people grow up and their perception of money is, will shape their decisions. My wife's grandfather grew up during World War II and has a big aversion to debt, always saving for emergencies. He may know rationally that investing in the stock market is better, but reasonably, he can't do it. He needs to know he'll sleep at night with no debt.

Lawrence: Exactly. At the crux of every financial decision is the question: does this help me sleep at night? That's fundamental. A perfect example is Harry Markowitz, who won the Nobel Prize for exploring the mathematical trade-off between risk and return. So, finding the optimal portfolio. I'm kind of a financial nerd. He's a legend. He finds the perfect combination of risk and return. He understood that he should be closer to 100% stocks but is actually in a 50/50 portfolio, 50% stocks and 50% bonds, because it helps him sleep at night. So, he is of all the people in the entire world to be invested in the optimal portfolio. That's his discovery. He understands that he's invested in a way that suits him, that helps him sleep at night. That's important.

Marcelo: It reminds me of Isaac Newton falling for the herd mentality during the South Sea Bubble. Here's a guy who discovered gravity and still made investment mistakes. Just because you're smart doesn't mean you'll always do the right thing.

Jackson: The way you behave is more important than your knowledge.

Lawrence: That's Morgan's quote and one of the guiding principles of the book. Understanding your psychology and controlling your behavior is crucial. Another great example that Morgan outlays on mending what's rational and what's reasonable was a paper in 2008 by some Yale researchers on the use of leverage in investing. Now, what they found is that young investors should have a two to one ratio of leverage. So for every $1 they own. They borrow $2 and they invest that sum of money into stocks. And then over time you taper off that risk. So what it's saying is that since you have a long horizon, you could borrow a lot of money and invest those proceeds because when you use leverage, it magnifies the risk in return. So if you're two times leverage, a 20% up in the market, you get 40%. But the opposite is true that if markets are down 20%, you're down 40%. So it doubles. And what they said is that you would be significantly better off by doing that throughout your life and sticking to this two to one leverage and then tapering off over time. But that is absurdly unreasonable. No person could be two to one levered. If the markets are down 50%, you get completely wiped out because he was 100%. So that's a perfect example of sure on paper that works out. That's all great. They crunched their numbers. But no reasonable person could actually do that plan.

Marcelo: Absolutely. What's the takeaway here?

Lawrence: The takeaway is there's no one-size-fits-all in finance. Everyone's unique. Their circumstances, behavior, and perception of the world are unique. You have to find the balance between what's rational and what's reasonable.

Marcelo: And I think that's the role of the advisor there. Our role is to understand every single client, have a transparent way of communicating it. And once you present, you have to crunch numbers sometimes and you have to present it to clients and you have to work with that middle of the pack or like what that magic point is in the middle. So I think it's a great point. We've covered two very important topics right now. So we have the third one, which is, I think one of the biggest ones too, because this is relevant for young investors, for old investors and for everybody at large. So it's the power of compounding and being patient. So let's go over that.

Lawrence: I'm sure a lot of our listeners understand the power of compounding and how important it is in finance. You may have seen some spreadsheets or charts where you see the exponential growth and the chart goes up into the right as your interest builds more interest. But I think that we need to spend a little bit of time really digging in because the power of compounding cannot be overstated. I think a perfect example that Morgan Housel, the author, uses is he references Warren Buffett's net worth over time. Warren Buffett started investing when he was 12 years old and he's been investing throughout his entire life, making good decisions and also some bad, but staying invested the whole way through. Now, of the $85 billion in net worth that Warren Buffett has, $82 billion of that was earned after his mid-sixties. So close to 99 percent of his net worth. And that's so striking because that really speaks to the power of compounding over time. That wealth really comes at the tail end.

Marcelo: Like I've seen these graphs where for young people, for example, like the amount you save at the beginning of your career, let's say from 25 to 35, it's more important than the return that you're earning in your portfolio. And as you age and you move away from like, you're starting to like turn 40, 45, The return of your portfolio is more important because you're going to have that base where the compounding is going to grow. At the end of the day, compounding is just growth over growth. It's growth on growth. So the fact that you were telling me that 90 percent of his net worth came after he was 60 is, is completely crazy to me.

Lawrence: It's a little rudimentary, but I think it's a pretty striking example and it helps people understand what exponential growth means. That's growth on growth. Human beings can understand linear growth—you see a straight line going up to the right. Understanding exponential growth is quite something.

Marcelo: It's harder to see it visually.

Lawrence: Exactly. The brain can't quite get it. Anyway, a perfect example is the question of whether you would rather have a million dollars today or a penny that doubles every day for a month.

Jackson: It's funny that we have this example here because when I was 15 years old, my dad asked me this question. Like the guys here already said, it's hard to comprehend compounding and exponential growth. Obviously, the 15-year-old me said, "I would like the million dollars today." That's quick cash.

Marcelo: I think a lot of people would say that, just because it's available right now and it's impactful when you hear "a million dollars" versus "a penny."

Lawrence: A penny that doubles every day for 30 days? There's no way that could be a lot of money, right?

Jackson: Exactly. It sounds like such an easy win, but look, Lawrence, take us through the numbers here.

Lawrence: On day one, you have a penny, day two, two pennies, then four pennies, and so on. You only crack $100,000 on day 25 out of the 30. So, 25 days in, you're like, "There's no way I'm going to make this up. I'm way behind." The million dollars is looking very sweet right now. But the next day, you're at $300,000 and so on. At the very end, on day 30, you're at $5.3 million. So more than five and a half times. And it was all in those last handful of days. So that's the importance here—that all that compounding really pays off the more time you have. A perfect example is to visualize a hockey stick—it's flat for a while and then it really ramps up at the tail end. That is what compounding is: time in the market is super valuable.

Marcelo: I don't want to deviate too much, but I've had many instances where people come to us and they're a bit younger, you know, 35, and their main concern is their portfolio. I've had to sit across from people and say, "Look, you do not have an investing problem. You have a savings problem." And I think if people understood the power of compounding, they would not fall for those pitfalls. I think that's a fantastic example, and I think that should be taught to kids from a very young age. But guys, just like this is magical, the opposite is true as well. So what happens when you have debt?

Lawrence: So there's negative compounding as well. You have interest rates on the opposite side. There's an example I actually found on the CRA website, which I think is great. This is what happens if you have a $2,000 balance on your credit card. Credit cards have a very high interest rate. That would be the worst debt to own. In this example, they're using 18%. It could be 25% now, 28%. So you have a $2,000 balance. In example one, you pay $60 a month—the minimum payment, let's call it. In scenario two, you pay $160—a hundred dollars more. If you zoom out, in scenario one, where you just did the minimum, it takes you almost 14 years to pay off. Just paying the minimum payment is the interest compounding, constantly carrying that balance. Now in scenario two, you pay it off in a year and a half. So 14 years versus a year and a half. And in the first example, where it takes you 14 years, you pay double because the interest kept compounding and you carried that balance for longer. You took longer to pay it off. And that's extremely important too.

Marcelo: This is important for young people to understand, I mean, anybody who holds credit card debt, because credit card debt will compound a lot faster because you're not talking about 5-6% like the market can give you over the long term. You're talking about 18%. It's huge. So I think that's a perfect segue for the next section we're going to talk about: social comparison. Walk me through that.

Lawrence: This is a fundamental part of being a human being. You're always comparing yourself to what's around you in terms of wealth and money. It's often objects. It's often things. There's always a faster car. There's always a bigger home. And it's always about who you compare yourself to, which could be the downfall for a lot of people—it's not keeping your spending in check. There is a difference between a person being rich and a person being wealthy. And wealth is what you don't see.

Marcelo: That's a great quote.

Lawrence: Yeah, I think that's quite striking. Morgan uses a really nice example about a rookie baseball player who just comes into the league. He signs his first contract. It's $500,000 a year. To any person, that's a lot of money. You're rich, objectively. But if this rookie is in the same locker room as Mike Trout, who just earned a 12-year, $430 million contract, relatively speaking, now this rookie looks poor. And then you kind of take that to the next level. The people in Mike Trout's inner circle—Mike Trout is one of the best baseball players in the world. He probably hangs around some high-flying people, let's call them hedge fund managers. So his inner circle—that's who he compares himself to. To be in the top 10 highest-paid hedge fund managers at the time of this book, you had to earn $340 million per year. So now we're talking about a whole other magnitude of wealth. Now Mike Trout, relatively speaking, looks poor or not quite as rich. It's all about who people compare themselves to.

Marcelo: We've seen the studies where one of the biggest predictors of what people are going to drive is their neighbors or where they live. We know that as human beings, we seek validation through social proof and our choices of the stuff that we buy—the cars, the houses, the schools we go to. But I think the important thing is, we've said this many times, it's not to judge someone who's buying a BMW or an Audi. If you like cars and you can afford it and you have a financial plan that works and you're sticking to it, a hundred percent, go for it. I think the problem is when you're buying those things and you're getting into the pitfalls of not saving enough, not getting ready for retirement, you're getting into debt. Think about the compounding we just talked about. Think about the situation. Now you're buying a car, you're paying 8-9 percent interest. So that compounds quickly. It's huge.

When it comes to financial planning, the social comparison now with social media as well, it's just a huge part of sticking to a plan.

Lawrence: And it also ties into what's reasonable versus what's rational. If you could afford that fancy car, it can be a sports car. It just has to make sense. It's all about trade-offs. But unfortunately, people get kind of sucked in and they borrow to buy these cars or there's too much house, for example, and that's where things get quite destructive—overextending yourself. It's the hedonic treadmill. You're constantly on this loop of bigger and better things. It never ends because there's always someone who has more money than you or makes more money than you and has nicer things. That's just a part of life. Not getting sucked up in that is really one of the biggest things you could do in your financial life.

Marcelo: There's a great example in the book where he's talking about when he was a valet in the valet service and people come with expensive cars and he says people usually care about the car, not the person driving the car. So nobody will care about these things more than you do. It is a big problem. So what is the takeaway here, guys?

Lawrence: Yeah. So as we said, the big takeaway here is not to get sucked up with the goalposts moving over time. As you go through your financial life, go up in your career and your money, it's very easy to constantly move the goalposts to keep upgrading things in your life, and that's not how you build wealth.

Marcelo: When you say the goalposts, you're really saying: what is enough? Figuring out what is enough for you. Exactly. We're going to wrap up here and I think we're going to end up with what I think, and I think you guys agree, is one of the most important sections in the book: building healthy financial habits. So let's go through that. What are some of the healthiest financial habits that we can find? I think you've identified a few and then let's wrap it up.

Jackson: I think building healthy financial habits is such a great thing to do, especially when you start young. Before I get into that, let me just break down what a habit even is. Google's definition of a habit is an acquired mode of behavior that has become nearly or completely involuntary. The reason why I'm advocating for starting these healthy habits young is because when you do so, that's when they become nearly or completely involuntary. You know, 10 years down the line, 15, 20 years down the line, it's almost like second nature.

Marcelo: Exactly. It becomes seamless. It's not even that hard to do anymore.

Jackson: There are so many reasons why you should start young because once you have those good, healthy financial habits, and once you have a long time horizon, that's when the odds of your investment success go up. I have a couple of healthy financial habits here. I'm going to name my top three, but there are so many healthy financial habits that you can develop and gain over time. To name a few here, I have "pay yourself first." That would be before you go out and spend your money, put some towards your savings so that way you're not spending first and then saving what little you have left.

Marcelo: That's a big one.

Jackson: The second one, which we already sort of talked about, was developing an investment philosophy. These are your guiding principles of how to invest and how to make investment decisions when times get tough and when your emotions are heightened.

Marcelo: That would be your investment North Star.

Jackson: Exactly. The last one, which I'm going to talk about a little bit more, is to tune out the noise. What I mean by the noise is there's so much financial media, so many people talking about negative financial advice, giving you advice that doesn't necessarily apply to you. Having the ability to tune out all that noise will give you probably the most amount of success over the long term. There's this quote that historian Deirdre McCloskey said in Morgan Housel's book: "For reasons I've never understood, people like to hear that the world is going to hell."

Marcelo: Yeah, that's a good one.

Jackson: This quote is mainly speaking to the fact that people give so much attention towards pessimism and they brush off optimism. I have a leading quote here to follow up the last one. This is Morgan Housel's quote in the book: "Tell someone that everything will be great and they're likely either going to shrug you off or offer you a skeptical eye. Tell someone they're in danger and you have their undivided attention."

Marcelo: That is so true.

Jackson: People pay attention to pessimism. They listen to the financial media when they think there's a recession coming or when the market is going to correct and they give way too much weight to that media, those pieces of advice when realistically they're probably not that applicable to you. I have an example here from the book. It's talking about the frequency of recessions over a 120-year period. It goes like this: There were 1,428 months between 1900 and 2019. Just over 300 of them were during a recession. By keeping your cool 22 percent of the time and staying invested, you reap the rewards that the markets offer. That's the importance of tuning out the noise because if you can stay invested through recessions and not try to time it, you are definitely going to capture everything that the market has to offer.

Marcelo: That's Ronald Reed right there.

Jackson: Yeah, exactly. That's the janitor right from the beginning of the book.

Lawrence: For those listeners, that's 20 percent of all months in the U.S. market in the last century and a bit were during a recession. You see those charts of the S&P 500 going up and to the right and incredible wealth being built. This is true for any market. Just because there's a recession and there's always a next crisis—that's how these talking heads and these pundits and these market experts make their money. A little bit of doom and gloom, because that gets the clicks and the eyeballs. That is not investment advice. They do not know who they're talking to. If they're giving you stock picks or saying to buy this or sell that, or rotate from stocks to cash, they don't know your circumstances.

Marcelo: It's the reason why it's easier to be a pessimist than an optimist. It's easier to destroy than build something. I think the financial news understands people's psychology. I don't know if you guys have seen this, but I remember reading a study not long ago that said that the ratio of negative news to positive news is somewhere like 18 or 19 to one.

Lawrence: Wow.

Marcelo: So it's absolutely crazy because they understand human psychology. They understand what drives clicks and eyeballs and they understand what drives attention to them. The difference is that they don't understand what your circumstances are. We sit across from people, we listen to them, we know what their goals are. We work with them to understand what their goals are. That's what helps us understand how a plan should be built, how an asset allocation should work. The fact that they're recommending people to do things with their portfolio and their money, it's absolutely crazy. It's entertainment, not advice.

Lawrence: I'm going a little bit on a tangent here, but one of the biggest things in finance that will correlate with your success over time is minimizing the mistakes and, you know, reacting to the flavor of the day. The news of the day will likely inevitably be a mistake. The best you can avoid those and just stay with it, the better off you'll be.

Marcelo: I think that's a great way to end the episode. Any last comments? I think we've covered pretty much everything. I mean, it's a big book. It's hard to do it justice in one episode, but I think we've covered what we think are the most important points with good takeaways for our clients and our listeners. Anything else?

Jackson: I would encourage everybody to read the book. It'll make you think extra hard. There are some very elegant stories in there. We covered five of them today. I think there are about 80 in there. It'll make you think about money in ways that you've never thought about.

Lawrence: It's super readable. It's not like a textbook. I think any person would be very well served reading it. And with that, Jackson, it was very nice to have you on the show.

Jackson: I hope I'm back again sometime soon.

Marcelo: Good episode, guys. This was a lot of fun. Thank you for listening.

Lawrence: Take care.

Jackson: Thanks.

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