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Insights

Financial & Business

Book Summaries

by Edelweiss Mutual Fund

“Reading gives us someplace to go when we have to stay where we are”

- Mason Cooley

Happy Reading!

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A Piece of the Action -
How the Middle Class Joined the Money Class
Author: Joseph Nocera

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Book Summary

Joseph Nocera's "A Piece of the Action", traces how middle class America got from being credit and savings agnostic to embracing the same. Mapping out the economic and investment landscape of the latter half of the 20th century, Nocera's book sheds light on the role of double-digit inflation in the 1970's in making middle-class households interest-rate conscious, the inventions of restless financial revolutionaries and financial deregulation. Written with flair and deep insight, it is a book that every participant of the financial market must read.

Key Takeaways

- While credit cards had a bit of a rocky start, the Great Inflation of the late 1970s and early 1980s encouraged middle class America to abandon thrift and embrace debt.
- Charlie Merrill, the founder of the firm Merrill Lynch strongly believed that financial education can convince the average American to invest in stocks and bonds.
- Government regulations imposing a cap on interest rates offered by banks on deposits were instrumental in the acceptance of money market mutual funds.
- Mutual Funds gained further acceptance due to the promise of future yield.
- The idea of “non-banks” was an ingenious way for institutions to side-step the hurdles set up by regulation.
- Innovation in financial instruments enabled middle class America to save, invest and consume better.

The birth of the ubiquitous credit card

The money revolution really started way back in the 1950's, although this is now obvious only due to the benefit of hindsight. At that time, the laws in America mandated that all banks pay the same interest on passbook accounts, which were the primary vehicle for middle class savings. In the 1950s, the rate never climbed above 3%. The law also mandated that checking accounts carry no interest at all. At the same time, other alternatives for middle-class savings were largely non-existent. Since there was nothing to differentiate one bank from another, most people chose the bank that was most convenient. However, it wasn't just the law that kept away middle class investors; it was also a great deal of snobbery. Up until the 1970s, when alternatives to passbook accounts finally forced banks to pay attention to their middle-class customers, most bankers looked at middle class business with disdain. In the banking world of that time, banks only valued the business from corporations, not consumers. Making loans to large companies was the most prestigious activity in all of banking; making consumer loans, on the other hand, was considered slightly disreputable, and such loans were ceded to finance companies, which was also considered slightly disreputable.

Bank of America was different, and it changed the way Americans saved and consumed. It eagerly embraced the middle-class customers that other banks looked down their noses upon. The result of that was the consumer credit card that Americans eventually embraced with a fierce vengeance. One day, back in September of 1958, the unsuspecting citizens of Fresno, California became the subjects of a corporate experiment that was to transform the financial services industry and the habits of tens of millions of Americans and countless others around the world. On that day, Bank of America air dropped on 60,000 unsuspecting citizens, a piece of blue and orange plastic about the size of a business card emblazoned with the less-than-catchy name, BankAmericard, now better known as VISA. This card gave them a chance to avail of what amounted to a small unsecured personal loan. The credit card had arrived and with it consumerism, consumer indebtedness, and consumer bankruptcy took new leaps forward. The Visa company, as we know it today, was actually a last ditch effort to save the failing BankAmericard franchise system. When BankAmericard was rolled out across the country, no one really gave much thought to the need to govern the relationship between issuing banks, especially when customers used cards outside the purview of the issuing bank. Back then, banks started to cheat each other and the system was close to failure when a fellow called Dee Hock at Bank of America suggested the creation of a governing body which at some point evolved into the Visa company that we know today.

Bringing Wall Street to Main Street

Charlie Merrill, the founder of the firm Merrill Lynch had a very simple dream. He wanted to “bring Wall Street to Main Street”. Considered to be the greatest populariser of the stock markets, he spent his entire career trying to convince the middle class that stocks and bonds should be a part of their lives. His central idea that the middle class should be investors as well as savers, lies at the heart of the money revolution. Merrill believed that in the long-run, Wall Street would not prosper unless it broadened its horizons. At that me, the stock and bond markets were completely an insider's game, scorning small investors. A survey at that me found that small investors looked at the stock markets with suspicion and mistrust. In order to change peoples' perception, Merrill launched a massive public relations campaign that far outlived him. In addition to positioning Merrill Lynch as a broker that operated on a higher moral ground than his less scrupulous competitors, the campaign also focused on reacquainting the Americans with stocks and bonds. Merrill held the belief that people would not come to the stock market unless they understood it. He regularly wrote articles educating small investors about the stock markets and encouraging them to invest their money in stocks and bonds. He was a believer in the virtue of long-term investing and was outraged whenever he overheard one of his salesman encouraging someone to buy a stock to make a fast profit.

The Age of Inflation

Inflation scared the American people like never before. The Great Inflation, the period between the later 1970s and early 1980s had a profound impact on middle class America's relationship with money. Of the many ways that Americans adapted to inflation, two changes stood above the rest. The first was a pronounced shift in the attitude of the middle class, particularly those young enough to have missed the depression, towards credit and credit cards. The thrift and risk aversion that stemmed from the depression era was finally abandoned during the raging infla on of the late 1970s and early '80s. Faced with double-digit inflation, volatile interest rates and a falling standard of living, consumers took respite in debt. Americans began borrowing as they had never borrowed before – borrowing that was facilitated by the near universal acceptance of credit cards, a condition that had arrived by the late 1970s.

The second was a shift away from regulated bank passbook accounts and toward “savings” vehicles that offered market rates of return. A large number of Americans finally realised that the biggest threat to the stability of their financial future was Regulation Q, which banned banks from raising interest rates even as “market” interest rates were rising rapidly. This was when the imperatives of infla on finally shook the middle class into ac on. The result was a swarm of people moving their savings out of bank passbook accounts and into money market funds.

It was also the moment when it was clear beyond all doubt that the money revolution had arrived. The emergence of two-income couples, adjustable-rate mortgages, credit cards and the middle class's growing participation in stocks, mutual funds and money-market accounts defined the money revolution.

It is important to understand that money market mutual funds might never have come into existence in the 1970s if it had not been for Government regulations that kept an unrealistic cap on the interest rates that banks were allowed to pay. It was only a matter of me before depositors would get frustrated due to the Government imposed interest rate ceilings prevented them from getting market yields on their savings. Even banks that wanted to pay market rates in order to keep their old depositors, or attract new ones, were not allowed to do so. Bank certificates of deposit carried market interest rates only if they were in denominations of USD 100,000 or larger. Small depositors who had probably just a few thousand dollars to invest turned to Treasury bills to get a better yield. However, not wanting to give a breather, the United States Treasury countered by raising minimum bill denominations from USD 1,000 to USD 10,000.

In that atmosphere of frustration, money market mutual funds gave renewed hope to the American middle class. These money market mutual funds gathered together the funds of many small savers, in batches as small as USD 1,000, and then packaged them into larger bundles to meet the minimum denomination requirements of certificates of deposit, Treasury bills and other money market instruments. At that me, these money market mutual funds were free to offer competive interest rates.

Mutual Funds knocking on Middle America's doors

By the fall of 1982, the Age of Infla on had effectively come to an end. That year, the Consumer Price Index rose a meagre 3 percent, and except for one year, stayed in the general range for the rest of the decade.

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The Great Bull Market of the 1980s – the second greatest bull market of this century, and the event that most dramatically shaped personal finance as Americans emerged from the Age of Inflation – began in the middle of August 1982. During the Age of Inflation, Fidelity earned the distinction of becoming a company that eschewed commissions. It started marketing its money funds directly to the public, without relying on a commissioned sales force. Fidelity's Ned Johnson changed the structure of the markets by completely abandoning commissions on Fidelity's other funds as well, and began selling them all directly to the public, cutting out the traditional broker-dealer network. This happened in 1979. In doing so, Ned John finally brought “Wall Street to Main Street”. Fidelity executives began to believe that their real function was not trading stocks, or researching companies, or even selling mutual funds. Instead, it was gathering assets. Another consequence of this direct selling was that Fidelity began relying heavily on technology. What Fidelity essentially learnt from the Age of Inflation was that “yield sells”. With this mind, Fidelity opened its flagship fund, the Magellan Fund managed by the star fund manager Peter Lynch, to the public in the summer of 1981. It was selling, much like the rest of the mutual fund industry at that time, that the manager running this wonderful fund would be able to keep churning out these fabulous returns. People were more than happy to buy this idea. The phenomenal success of mutual funds in the 1980s was built almost entirely on the promise of future yield, which in turn was based on past performance.

The birth of Non-Banks

Andrew Kahr, the inventor of Merrill Lynch's cash management account and the Schwab One Account, devised the ingenious concept of a "nonbank bank. The "nonbank bank" idea had enormous ramifications for the financial services industry. Most of all, it undermined the functional separation of commercial and investment banking, a bedrock financial principle that had been sacrosanct since the enactment of the Glass-Steagall Act in 1933. As per the statutes of the act, commercial banks were defined as institutions that both accept demand deposits and make business loans. However, Mr. Kahr came up with the ingenious idea that by dropping one of these functions, usually the making of business loans, institutions could transform themselves into "nonbank banks". This would enable them to continue their core business of dealing in checking accounts but would ensure that it is no longer by the numerous Government restrictions that had historically confined the activities of commercial banks. Once the Federal Reserve Bank gave its reluctant approval to the "nonbank bank" concept, the floodgates literally opened. Financial institutions went on an innovative spree, creating structures and partnerships previously unheard of. The Bank of America promptly acquired Charles Schwab & Company, a discount brokerage house; Merrill Lynch, Dreyfus and Prudential-Bache bought commercial banks, and Security Pacific National Bank bought a seat on the New York Stock Exchange. This gave birth to an era where banks entered the securities business while brokerage houses ran a banking business. It all became a bit of a hotchpotch, making it to distinguish one kind of financial institution from another.

The credit card was but the first of a series of innovations in financial instruments that includes the money market account and mutual funds. These innovations have been instrumental in inviting the middle class into the fold of financial services and giving them equal access to financial instruments that has so far been the exclusive domain of the moneyed and propertied class. They enabled to middle class to enjoy a tighter control over their own finances.

“The rich invest in time, the poor invest in money”

- Warren Buffet

The Intelligent Investor

Author: Benjamin Graham

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Book Summary

The Intelligent Investor, written by Benjamin Graham in 1949, is possibly the most important and influential value investing book ever written. A bible for all investors, it made the concept of investing simple and easy to understand, so that even an ordinary individual could become an "intelligent investor". The book is also famous for introducing two concepts into the investing profession: the allegorical Mr. Market and the concept of "margin of safety." Warren Buffet described it as "by far the best book ever written on investing".

Key Take-Aways

- Investors are of two main types: the "enterprising investor" and the "defensive investor"
- It is important to understand the difference between speculation and investing
- Enterprising investors should treat investing like a business and commit their time and energy to the same
- Most investors don't have the time to see investing as a business. Hence, they must follow a defensive strategy
- There is no evidence to suggest that market timing and forecasting work
- Value investors must focus on the operating performance and dividends of the firm they own rather than the changing stock price
- When measuring value, check the firm's earning ability. Then multiply and adjust the asset values
- Shareholders must check the reliability of management
- Stockholders are responsible for ownership. They also have certain rights. Hence, stockholders must employ them seriously and consistently
- Always employ a margin of safety to limit your downside

Be an Intelligent Investor – Understand the difference between Investment and Speculation

The intelligent investor is one that is patient, disciplined and eager to learn. They are also able to harness their emotions and think for themselves.

"This kind of intelligence is a trait more of the character than of the brain."

The first step towards being an intelligent investor is understanding the difference between investing and speculating. Investing entails a thorough analysis of an investment that includes determining the risk/return characteristics of the asset. An investment has the ability to promise safety of principle and an adequate return. Speculation, on the other hand, involves taking investment decisions that are not made on a foundation of research and analysis and can consequently lead to a high probability of loss of capital. Investors should limit their allocation to speculative positions (also known as "mad money account") to no more than 10% of the investment funds. Never mingle the money in the speculative account with the money in the investment account.

"Stocks do well or poorly in the future because the businesses behind them do well or poorly - nothing more, and nothing less."

The intelligent investor will never exit a stock position purely in response to share price movement. He / she will always first ask whether the value of the company's underlying business has changed and then act accordingly. The intelligent investor only pays attention to the current stock price when it suits him. The investor who permits himself to be worried by unjustified market declines in his holdings is essentially transforming his basic advantage into a basic disadvantage. The speculator's main interest is to anticipate and profit from fluctuations in the market. The investor's primary interest is to acquire and hold suitable securities at suitable prices. Investing is not about beating others at their game, it's about controlling yourself at your own game. Most investors fail because they pay too much attention to what the stock market is doing currently.

Stock Market Volatility – An Introduction to Mr. Market Concept

Imagine that we own small shares in a private business that costs us $1,000. One of our partners is called Mr. Market. Mr. Market is a very obliging partner. Every day, he tells us what he thinks our interest is worth and furthermore, offers either to buy us out or to sell us an additional interest on that basis. Sometimes his idea of value appears justified and plausible by business *developments and prospects as we know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*

If we are a prudent investor or a sensible businessman, will we let Mr. Market's daily communication determine our view of the value of a $1000 interest in the enterprise? Only when we agree with him, or we want to trade with him. We may be happy to sell out to him when he quotes a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time, we would be wiser to form our own views of the value of our holdings, based on full reports from the enterprise about its operations as well as its financial positions.

Inflation – The Silent Raider

Inflation is real and it erodes our purchasing power over time. A dollar 10 years ago is worth more as compared to A dollar today. What this means is that cash is a terrible investment. We need to make use of the cash, to get more cash. We need to invest cash to beat inflation. Investors often overlook the importance of inflation. Psychologists called this the "money illusion". For example, if we receive a 2% raise in salary in a year when inflation runs at 4%, we will most certainly feel better than if we take a 2% pay cut during a year when inflation is zero. Yet, both changes in the above mentioned scenarios leave us in a virtually identical position: Which is 2% worse after inflation. Investing in stocks for the long-term and REITs can help investors guard their earnings/investment returns from the ill effects of inflation.

What Type of Investor should you be?

It is widely believed that the return you can expect from an investment is directly proportional to the risk that you are willing to take. This basically translates into the belief that high risk equals high return while low risk equals low return. However, the rate of return that an investor can expect is not only a function of risk but also of the amount of effort he/she is willing to invest in research.

To determine the amount of risk you can take, ask yourself:

- Are you single or married? What does your spouse or partner do for a living?
- Do you or will you have children? When will the tuition bills hit home?
- Will you inherit money, or will you end up financially responsible for aging, ailing parents?
- What factors might hurt your career? (If you work for a bank or a homebuilder, a jump in interest rates could put you out of a job. If you work for a chemical manufacturer, soaring oil prices could be bad news.)
- If you are self-employed, how long do businesses similar to yours tend to survive?
- Do you need your investments to supplement your cash income? (In general, bonds will; stocks won't.)
- Given your salary and your spending needs, how much money can you afford to lose on your investments?

For the defensive investor - high-grade bonds and common stocks

The defensive investor should divide his funds between high-grade bonds and high-grade common stocks. The standard division should be equal ones of 50-50 between stock and bonds. A sound reason to increase the percentage in common stocks is when there are more stocks in a bear market at a bargain price. Conversely, they should reduce common stock component to below 50% when the market level has become dangerously high. Investing in investment funds is more suitable for the defensive investor.

Stock selection for the defensive investor:

1. Adequate size of the enterprise - Exclude small companies that are more volatile
2. A sufficiently strong financial condition - Current assets should be at least twice of current liabilities for industrial firms. Long-term debt should not be more than net current assets. For public utilities, the debt should not exceed twice the equity

3. Earnings stability - Positive earnings for each of the past 10 years
4. Dividend record - Uninterrupted for the past 20 years
5. Earnings growth - A minimum increase of at least one-third in per-share earnings in the past ten years using three-year averages at the beginning and end
6. Moderate price to earnings ratio - No more than 15 times average earnings of the past 3 years
7. A moderate ratio of price to assets - Should not be more than 1.5 times the book value last reported. However, a low PE ratio below 15 can justify a higher price to book value. PE ratio x PB ratio should not be more than 22.5

Stock selection for the enterprising investor:

1. Financial condition: [1] Current assets at least 1.5 times current liabilities, and [2] debt not more than 110% of net current assets (for industrial companies)
2. Earnings stability: No deficit in the last five years
3. Dividend records: Some current dividend
4. Earnings growth: Consistent earnings growth
5. Price: Less than 120% net tangible assets

It is important to note that many of the best professional investors first get interested in a stock when its share price goes down, not up. Looking at the daily list of the new 52-week lows can be a great way to get started.

Investment Selection - How to Analyse Stocks and Bonds

When analysing bonds

The most important criteria to take note of is the number of times that total interest charges have been covered by available earnings. We should analyse for at least 7 years in the past.

For preferred stocks

It is the number of times the bond interest and preferred dividends combined have been covered by the available earnings for 7 years in the past.

For stocks

We have to compare our valuations of the company to the current price that the company is trading at in the stock market. We should always seek a margin of safety - purchasing the stock for less than its intrinsic value. The lesser the assumptions we have to make about the future during analysis, the lesser the possibility for error. Avoid making too many assumptions in your stock analysis.

Elements to determine how much the enterprising investor should pay for a stock:
1. Long-term prospects of the company - Gather evidence in the financial statements that answer two questions: What makes this company grow? Where do (and where will) its profits come from? Look for companies that:
  a. Have a wide "moat" or competitive advantage
  b. Prefer to run marathons and not sprints
  c. Focuses on what it is sowing
2. Management competency - Look for management that says what they will do, and does what they have said. A good management will admit failures and take responsibility for them
3. Financial strength & capital structure - A good business generates more cash than it consumes. See in the statement of cash flows whether cash from operations has grown steadily over the past 10 years

4. Dividend record - One of the most persuasive tests of high-quality companies is an uninterrupted record of dividend payments going back over many years (20 years is preferred)

5. Current dividend rate

6. Be a long-term thinker - Looking at the longer term provides a better indicator of the future health of the company.

7. Look into the footnotes - Be wary of aggressive revenue recognition practices. It is a sign of dangers that run deep and large. Also be wary of companies that do not charge expenses against revenues when it is suitable to. Instead, they treat these expenses as a capital expenditure that increases the company's total assets instead of decreasing net income.

Margin of Safety – The Most Important Concept

Margin of safety in stock investing is the difference between the intrinsic value of the company and the price we pay to purchase it. The amount of price paid is the most important factor in investment.

Determining the purchase price, and having the discipline to only buy at or below the price is where the true test lies at. A sufficiently low price, relative to the actual value, can turn even a mediocre quality stock in to a great investment opportunity. The greater the margin of safety, the more leeway we have for things to go bad - before we lose money. If the future is as we expect it to be, the profits generated from that investment will also be much higher.

Unfortunately, not many people in the world can make an accurate forecast into the future of a company. There is always a risk of paying too high. The reason for having a margin of safety is essentially to make an accurate forecast of the future less necessary. There is a buffer for inaccurate forecasts. One of the main reasons for investor's loss is that they buy low-quality stocks at times of favourable business conditions, without a margin of safety.

Diversification is a key component of "margin of safety"

The odds would be with us when we only invest in individual stocks with a large enough margin of safety. While some stocks will live up to our expectations, many others will not. Diversification can amplify the benefits of margin of safety. A diversified portfolio has a higher probability of generating above average returns.

Eleven rules that can help both analysts and investors:

- Estimate the earning capacity of a company to measure value. Multiply this correctly and take into account asset value
- Earning capacity is an estimate of the firm's earnings over the next five years
- Guess a firm's average earnings over this period. You can do this by averaging past performance. Then estimate margins and revenues for the future
- Adjust previous years' numbers to reflect any changes in capitalization
- You should use a maximum multiplier of 20 and a minimum of 8. This allows for changes in earnings in the long-run
- If the value arrived at from earning power is higher than the fixed assets' value, subtract from the earnings value change. Suggested: subtract a quarter of the sum by which the earning-power value is higher than two-times the asset value. This allows for a 100% premium on tangible assets sans penalty
- If such value is lower than the net current assets' value, add 50% of the variance to the value measured on earning-power
- In unusual events, like war, short-term royalties or rentals, adjust the value accordingly
- Assign value among bondholders, stockholders or preferred shareholders. Before this step, compute the company value as though its capital structure had only common stock
- The more debt and preferred stock in the capital structure, the less you need to rely on the appraised value. Decisions should not be taken based on this value
- When the appraisal is one-third greater or less than the current market value, you can base your decision on this. If the difference is less, then the appraisal is just a factor to consider in the assessment

And always remember, investment is most intelligent when it is most business-like. **When we buy a stock, we become an owner of the company.**

"Never depend on a single income,
make an investment to create a second source"

- Warren Buffet

Principles: Life and Work

Author: Ray Dalio

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Insights

Book Summary

In his book "Principles: Life and Work", Ray Dalio puts together more than forty years of experience to create a set of principles that can help those who adopt them achieve success, in both life and business. In the book, he postulates that life, management, economics and investing can all be systemized into rules and understood like machines. He also lays out the most effective ways for individuals and organizations to make decisions, approach challenges and build strong teams.

Key Takeaways

- Everything in life follows patterns – these patterns can help you better understand why things happen in a certain way
- To be successful in life you need to be a hyperrealist
- It is okay to make mistakes. However, it is not okay to not learn from them
- It is important to be radically open minded and pay attention to other people' perspectives as well
- Effective decision making is contingent upon your ability to learn and then incorporate those learnings to make better decisions
- Cultivate an organisation where people value trust and transparency
- Understand that hiring the right people is integral to the success of the organisation
- Treat your people with respect and encourage an environment of open communication
- Institute a robust governance structure to ensure that all the cogs in the organisational wheel are functioning smoothly

LIFE PRINCIPLES

Most people want to be successful in life. They want to be successful at work and at home. They also want to have successful relationships. In order to be successful, you need to be a hyperrealist. Being a hyperrealist basically means having big dreams but also being realistic about your situation and having the determination to pursue your dreams.

Dreams + Reality + Determination = A Successful Life

Being truthful to yourself, or basically having an accurate understanding of reality is the essential foundation for any good outcome. You also need to be radically open-minded and radically transparent so that you are not only aware of the changes around you but are also agile enough to effectively adopt these changes. Instead of focusing on how you think that things "should be" focus on learning from how they really are. Embracing radical truth and radical transparency will bring more meaningful work and more meaningful relationships in your life. It will also help you evolve in a changing environment so that you can maximise your output and leverage on your full potential.

Always remember, "No pain, no gain".

It is a fundamental law of nature that in order to gain strength one has to push one's limits, which can be painful.

Pain + Reflection = Progress

It is always better to go through the pain than to avoid it. The process of change can be painful and can offer many learnings. You should learn to embrace these learnings. In order to optimise the outcome, you should ensure that the individual's incentives are aligned with the group's goals. Success comes when you optimise for the whole and not just for the individual.

Machine is the bedrock on which we build our success, therefore, you need to look at the machine from a higher level. Think of yourself as a machine that is operating within the larger organisational machinery. Understand that you have the ability to alter your machines to produce better outcomes. By comparing your outcomes with your goals, you can determine how to modify your machine. Learn to evaluate the second and third order consequences as well and take ownership of your own outcomes.

The biggest mistake most people make is to not see themselves and others objectively, which leads them to repeatedly make the same mistakes. Successful people are those who can go above themselves to see things objectively and manage those things in order to bring about change. Asking others who are strong in areas where you are weak to help you is a great skill that you should develop no matter what, as it will help you develop guardrails that will prevent you from doing what you shouldn't be doing. However, it can be challenging to see oneself objectively. Hence, it is imperative that you seek inputs from others. If you are open-minded enough and determined enough, you can get virtually anything you want.

Use the 5-Step Process to Get What You Want Out of Life
1. Have clear goals
2. Identify and don't tolerate problems
3. Diagnose problems to get at their root causes
4. Design a plan
5. Push through to completion

Always remember that weaknesses don't matter if you are able to find the solutions. Look at the patterns of your mistakes and identify at which step in the 5-Step Process you typically fail. Once you identify your biggest weakness then find a way to deal with it.

Be Radically Open-Minded

All humans have two barriers that stand in the way of their success.
a) Your ego barrier
b) Your two "yous" that fight to control you

The first step in overcoming these barriers is to practice radical open-mindedness. You might not always know the best possible path or have the most optimal solution. Your ability to deal well with "not knowing" is more important than whatever it is you do know. Optimal decision making is a two-step process that first requires you to glean all the relevant information and then make the decision. In order to gain the perspective that comes from seeing things through another's eyes, you must suspend judgment for a time and honestly evaluate another viewpoint. Always remember that you are looking for the best possible answer and not simply the best answer that you can come up with yourself.

Understand That People Are Wired Very Differently

Understand the power that comes from knowing how you and others are wired. We are all born with attributes that can both help us and hurt us, depending on their application. Understanding these attributes and then leveraging it for the greater good is integral to achieving success in life. Reconcile your feelings and your thinking and be cognisant of the differences between right-brained and left-brained thinking. Understand how much the brain can and cannot change.

Learn How to Make Decisions Effectively

The biggest threat to good decision making is harmful emotions. Treat decision making as a two-step process that involves:
Step 1: Learning
Step 2: Then deciding

One of the most important decisions you can make is to assess the situation and determine who to ask questions. You must inculcate an ability to distil information and be wary of everything that you hear. Make your decisions as expected value calculations. This entails understanding the probability of being right and then taking steps to increase this probability. Knowing when not to bet is as important as knowing what bets are probably worth making. The best choices are usually the ones that have more pros than cons, not those that don't have any cons at all. At the end of the day, use simple principles to guide you through your life.

WORK PRINCIPLES

An organization is a machine consisting of two major parts: its culture and its people. A great organization has both, great people and a great culture. In turn, great people tend to have great character and great capabilities. Irrespective of how great the culture and people of an organisation are, there will always be problems and disagreements that come to the surface from time to time. Great companies solve these problems well, and they love imagining and building great things that haven't been built before. Make your passion and your work one and the same and do it with people you want to be with.

TO GET THE CULTURE RIGHT

Trust in Radical Truth and Radical Transparency

Realize that the truth is your strongest armour and integrity your biggest weapon. Create an environment in which every participant has the right to speak and understand what makes sense and what does not make sense. However, ensure that no one has the right to hold a critical opinion without speaking up. Be radically transparent in your dealings with your people and ensure that the people in the organisation are equally transparent in their dealings with each other. Provide transparency to people who handle it well and either deny it to people who don't handle it well or remove those people from the organization. Meaningful relationships and meaningful work are mutually reinforcing, especially when supported by radical truth and radical transparency.

Cultivate Meaningful Work and Meaningful Relationships

Have a larger organisational goal and be loyal to the common mission and not to anyone who is not operating consistently with it. Make sure that people give more consideration to others than they demand for themselves and that they clearly understand the difference between fairness and generosity. Know where the line is and always be on the far side of fair. Recognize that the size of the organization can pose a threat to meaningful relationships and that most people will pretend to operate in your interest while operating in their own. Treasure honourable people who are capable and who will treat you well even when you're not looking.

Create a culture in which it is okay to make mistakes and unacceptable not to learn from them

Mistakes are a natural part of the evolutionary process. People fail all the time, however, that does not make them failures. It is important to fail well and to learn from your mistakes rather than feeling bad about them. Don't worry about looking good—worry about achieving your goals. Do not make the environment toxic with a “blame” and “credit” culture. Instead, adopt an “accurate” and “inaccurate” culture. However, know what types of mistakes are acceptable and what types are unacceptable, and don't allow the people who work for you to make the unacceptable ones.

Get and Stay in Sync

Recognize that conflicts are essential for great relationships because conflicts help people determine whether their principles are aligned and nudges them to resolve their differences. Dedicate a large proportion of your time and energy to getting in sync, because it's the best investment you can make. Have the ability to distinguish between idle complaints and complaints that can lead to improvement. Remember that every story has another side. Be open-minded and assertive at the same time. Also ensure that those in charge are open-minded about the questions and comments of others. Making suggestions and questioning are not the same as criticizing, so don't treat them as if they are.

Believability Weigh Your Decision Making

An effective idea meritocracy system requires that you understand the merit in each person's ideas. If you can't successfully do something, don't think you can tell others how it should be done. Remember that everyone has opinions and they are often bad. Find the most believable people possible who disagree with you and then try to understand their reasoning for disagreeing with you. Remember that believable opinions are most likely to come from people 1) who have successfully accomplished the thing in question at least three times, and 2) who have great explanations of the cause-effect relationships that lead them to their conclusions. If someone hasn't done something but has a theory that seems logical and can be stress-tested, then by all means test it. However, don't pay as much attention to people's conclusions as to the reasoning that led them to their conclusions. Inexperienced people can have great ideas too, sometimes far better ones than more experienced people. Pay more attention to whether the decision-making system is fair than whether you get your way.

Recognize How to Get Beyond Disagreements

While you need to create an environment that encourages communication, make sure that people do not confuse the right to complain, give advice, and openly debate with the right to make decisions. Don't leave important conflicts unresolved. Don't let the little things divide you when your agreement on the big things should bind you. Once a decision has been made, it is imperative that everyone should stand behind it, even though individuals may still disagree. Remember that if the idea meritocracy comes into conflict with the well-being of the organization, it will inevitably suffer.

TO GET THE PEOPLE RIGHT

Remember that the WHO Is More Important than the WHAT

The important decision for you to make is who you choose as your Responsible Parties (RPs). The most important RPs are those responsible for the goals, outcomes, and machines at the highest levels. Know that the ultimate Responsible Party will be the person who bears the consequences of what is done.

Hire Right, Because the Penalties for Hiring Wrong Are Huge

People make the organisation and thus hiring the right person is integral to the success of the organisation. Match the person to the design and not the other way round. Ruminate over the values, abilities, and skills you are looking for (in that order) and those that fit the job at hand. Then, find the right fit person between the job and the role. People are built very differently and they have different ways of seeing and thinking which makes them suitable for different jobs.

Make finding the right people systematic and scientific. Understand how to use and interpret personality assessments. Remember that people tend to pick people like themselves, so choose interviewers who can identify what you are looking for and look for people who are willing to look at themselves objectively. Also remember that people typically don't change all that much. Thus, it is important to pay attention to people's track records and check references. While it is always great to hire conceptual thinkers, do understand that there is no replacement for experience and track record. When considering compensation, provide both stability and opportunity. Remember that in great partnerships, consideration and generosity are more important than money. Be generous and expect generosity from others.

Constantly Train, Test, Evaluate, and Sort People

Just as organisations go through an evolution so do the people you manage. Personal evolution helps people understand their own strengths and weaknesses - hence, career paths should not be planned at the outset. Instead, they should be amorphous and take the shape of an individual's personal evolution. Understand that training guides the process of personal evolution. Teach your people to fish rather than give them fish, even if that means letting them make some mistakes. Make the process of learning open, evolutionary, and iterative. Recognize that experience creates internalized learnings that book learning can't replace. Provide constant feedback and evaluate accurately, not kindly. Don't lower the bar.

WORK PRINCIPLES TO BUILD AND EVOLVE YOUR MACHINE

Manage as Someone Operating a Machine to Achieve a Goal: look down on your machine and yourself within it from the higher level. Constantly compare your outcomes to your goals. Understand that a great manager is essentially an organizational engineer who needs to pay attention to what people are like and what makes them tick. Always remember that your people are your most important resource.

Perceive and Don't Tolerate Problems: design and oversee a machine to perceive whether things are good enough or not good enough. Understand that problems with good, planned solutions in place are completely different from those without such solutions. Think of the problems you perceive in a machine like way.

If you're not worried, you need to worry—and if you're worried, you don't need to worry.

Diagnose Problems to Get to Their Root Causes: to diagnose well, ask the following questions: 1. Is the outcome good or bad? 2. Who is responsible for the outcome? 3. If the outcome is bad, is the Responsible Party incapable and/or is the design bad? Always remember that almost everything will take more time and cost more money than you expect.

Do What You Set Out to Do: work for goals that you and your organization are excited about and think about how your tasks connect to those goals. Be coordinated and consistent in motivating others.

Use Tools and Protocols to Shape How Work Is Done: having systemized principles embedded in tools is especially valuable for an idea meritocracy. Use tools to collect data and process it into conclusions and actions. Foster an environment of confidence and fairness by having clearly-stated principles that are implemented in tools and protocols so that the conclusions reached can be assessed by tracking the logic and data behind them.

Don't Overlook Governance!

To be successful, all organizations must have checks and balances in place. Even in an idea meritocracy, merit cannot be the sole determining factor in assigning responsibility and authority. Ensure that no one is more powerful than the system or so important that they become indispensable. The organization's structure and rules should be designed in such a way that it complements the checks-and-balances system that is put in place. Make sure that the people doing the assessing 1) have the time to be fully informed about how the person they are checking on is doing, 2) have the ability to make the assessments, and 3) are not in a conflict of interest that stands in the way of carrying out oversight effectively. Integral to decision making is the right to access all the necessary information and an ability to make unbiased decisions. Remember that in an idea meritocracy a single CEO is not as good as a great group of leaders. No governance system of principles, rules, and checks and balances can substitute for a great partnership.

"Do not save what is left after spending but spend what is left after saving"

- Warren Buffet

The Most Important Thing

Author: Howard Marks

We have often heard people lament that the ground reality is different from what we read. "The Most Important Thing" by Howard Marks is just the opposite. Insights gleaned from decades of memos that billionaire value investor Howard Marks wrote throughout his investment career span the pages of this book, giving people a ground-up perspective on markets and investments. This book consists of opinions and insights from not only Howard, but also from investment educators like Joel Greenblatt, Paul Nicholson, Seth A. Klarman and Christopher Davis. Together, these experts talk about various concepts including defensive investing, opportunities, and second level thinking. Basically, the book outlines the strategies necessary for a successful investor and also defines the dangers associated with it, especially for people who tend to invest blindly. While the book illuminates the many aspects of investing it also succinctly discusses the concept of risk. Novice, as well as seasoned investors, can find value in the book. As the legendary investor Warren Buffet remarked about the book, "It is that rarity, a useful book".

Key Takeaways

- Successful investors possess a second-level thinking that helps them see things and find value where others cannot
- The Efficient Market Theory does not hold true all the time
- "Buying Low" and "Selling High" is not just about the price but also about the value
- It is important to determine the intrinsic value of a stock and then assess price relative to the intrinsic value
- Since the future is uncertain, there will always be some amount of risk involved in investing. Successful investors recognise this risk, understand it and then take steps to mitigate it
- Stock markets move in cycles. Identifying these cycles can be helpful in making good investment decisions
- Do not fall prey to your lack of knowledge. Learning is essential to becoming a successful investor
- Patience is a virtue and a great asset for the successful investor
- Investing has a dual goal – maximise returns while minimising losses

Second - Level Thinking

Earning average returns is not the most difficult task in the world. However, consistently earning above-average returns requires a special something that not all investors possess. While there are many people who are content with investing in anything that offers average returns, others want to stay a step ahead and beat the market. In order to accomplish this, it's necessary to be adaptive and intuitive instead of making investing a mundane and mechanised process. Although an investor can follow his role model and mimic his rules, he cannot actually perfectly mimic his role model to replicate the gains. What works for one investor might be disastrous for another. Therefore, in order to generate better than average returns, the most important thing an investor should possess is perceptive or second-level thinking. Second-level thinking is a thought process that will enable him to see beyond the obvious. This will help the investor find value and exploit opportunities that others might not see.

Understanding Market Efficiency (and Its Limitations)

A lot of financial literature waxes eloquent about the “Efficient Market Hypothesis”. Basically, the EMH states that all information relevant to a stock is publicly available and is immediately reflected in the price of the stock. While this concept does hold true most of the time, it is in no way sacrosanct. For instance, in January 2000, Yahoo was selling at $237, but in 2001, it had plummeted to just $11. Therefore, the market was wrong in at least one of these instances. When prices reflect the consensus, sharing the same view might only deliver average results. In order to beat the market, it's very important to have a unique and different view.

Value and the Relationship between Price and Value

“Buy Low and Sell High” is something that all investors attempt to do. However, in order to determine the “low” and the “high”, it's important to determine the accurate intrinsic value. Therefore, it's obvious that an investor needs to purchase stocks well below its intrinsic value and then sell it at a much higher price. The only way one can arrive at an accurate intrinsic value is through fundamental analysis. It is only after carefully evaluating a company, its current performance and its future growth potential can one arrive at an intrinsic value for the stock. Once an investor estimates the intrinsic value of an asset or stock, he/she can go ahead; however, even if the estimated intrinsic value is correct, it's equally important to figure out the asset/stock's price that is relative to the value. Therefore, it is very important to establish a good relationship between the fundamentals, value and the price. As a value investor, one must also be cognisant of the fact that price is merely the starting point and that no asset is too good to be true. Any asset that seems attractive at a low price should also seem like a bad deal when the price is way too high.

Recognising, understanding and handling risk is essential

It's not really impossible to find investments that could deliver outstanding returns in the future; however, an investor is probably not going to be successful if he/she shies away from dealing with risks. Investment performance is something that is going to happen in the future. So, risk is something that will have to be experienced either now or later. Risk simply means that you're uncertain about the future and also about the loss that you might incur. When prices are high, participating in the market along with the rest of the crowd rather than avoiding it could be a major risk. Similarly, there's no such thing as “low prices = low risk”. No matter what the value is, there is a certain amount of risk involved because it is not possible to predict the future. Risk assessment is essential due to three reasons. Firstly, since there are too many theories about risk, the investor has to first understand whether he can take it and live with it later. Secondly, the investor also has to think about the potential return. Thirdly, the investor will also have to assess the risk itself and evaluate whether it's worth it. Once you have assessed the risk, the next step is to mitigate or control it. While all investors face risk at one point of time or the other, bearing risk intelligently for profit is what makes an investor stand out from the rest. Great investors are judged for their capability to manage and control risk and also generate returns.

Cycles – The Ups & Downs

What goes up must come down and then go up again. Eventually, everything is cyclical and nothing moves in one direction for a long time. The mood swings of the market are similar to the swings of the pendulum. While it may swing from one extreme to another, it also swings from risk aversion to risk tolerance, from greed to fear, from optimism to pessimism and from low prices to high prices. In reality, we aren't capable of predicting which way the pendulum may swing. Even though it is next to impossible to predict things, it's definitely possible to prepare so that the loss or damage is controlled. When it comes to investing, there are many unknown factors. However, what is known is that stock markets move in cycles. Understanding and paying heed to cycles can be very instructive when it comes to investment decision making. There are only a few things that are sure. However, you can be absolutely sure that just about everything is cyclical. If you are attentive to cycles even when others stop paying heed to it, you are more likely to become a successful investor.

Learn, Be Aware and Combat Negative Influences

While there are many investors who suffer from inefficiencies such as mispricing, miscalculations and other mistakes, the ones who are cognisant of these mistakes and are able to address them will eventually be successful. Since it is not possible to identify what might occur in the future and since very few people have the wisdom of using their knowledge to their advantage, knowledge plays a major role in making the right investments. Therefore, an investor who is aware of his limited knowledge, no matter how knowledgeable he is, will definitely have an advantage over others. Market cycles have ensured that investors continue to face daunting challenges. Firstly, the highs and lows are inevitable. Secondly, the cycles will also influence the investor's performance and thirdly, unpredictability is not the only issue but the timing as to when it occurs can also make an investor lose sleep. Therefore, it is essential for an investor to understand where he/she stands. Of course, the cycles can help to estimate things to a certain extent, but cannot predict the future with certainty. However, it is most probably the best estimate. At the end of the day, investors should have realistic expectations. Often, people expect high returns with no or little risk. Here, greed and fear also make them forget the golden rules of investing. It's certainly tough to combat these negative influences, but the ones who refuse to join the crowd even when it is very tempting are the ones who will be successful.

Successful Investing

It is not always possible to find the best deals. Sometimes we hit and miss. The most important thing for an investor is to learn patience. Therefore, instead of chasing deals, it's a good strategy to wait for things to come your way. In addition, you should purchase something that the seller wants to sell rather than buy something only because you need or want it. Do not expect cycles to occur all the time and don't think that the market is under/overpriced all the time, because, everything can be balanced and there may be no mistakes. While most investors tend to follow the trend, superior investors go the opposite way. As stated by Sir John Templeton, "It takes a great amount of courage to sell when others are buying and buy when others are desperately selling". However, this strategy offers the greatest profit. One can't be successful by simply following the trend because if that was the case, just about everybody would have made money as an investor.

Therefore, in Howard's words, “the key to success lies in the fact that you sometimes do the opposite, even if the trend dictates that you become a part of the herd.” Another important thing to remember is that it is not necessary for a cheap stock to provide the best returns. Sophisticated investors do not simply buy the cheapest stock, but instead, they make a list of investment options that meet their own criteria. While these criteria may differ from one investor to another, they usually evaluate the risk involved. In addition, an intelligent investor should not always invest in a cheap stock because there could be a very good reason for it to be available at cheap valuations. For example, a product that might not be hot now could vanish into thin air years later and this could make an investor hesitant. The point here is that in order to become a successful and profitable investor, it is best to choose the best bargains after making a list of what you're comfortable with. Over and above skills, one must also accept that often there is luck at play. Markets can oft times behave in a random fashion in which luck and not skills might generate spectacular returns.

Investing Defensively and Avoiding the Pitfalls

An investor should strike a good balance between making money and avoiding losses. One can't make a great profit and avoid loss simultaneously. Basically, it's like choosing between offence and defence. The position an investor chooses will be critical for his decisions in investing. It is alright to invest defensively and avoid losses, rather than trying to hit winners and make money all the time. It is possible to avoid loss by recognizing the pitfalls one might face as an investor. Greed & Fear is often the main source of all mistakes and pitfalls. Investors should actively try to avoid these at all cost.

Adding Value

It's not very tough for an investor to gain some knowledge and perform according to the market's demands. However, investors who take it a step further and outperform the market are the ones who add real value to it. This takes skill and requires the investors to become second-level thinkers. Value is the very foundation for a good investment career. When an investor learns something others don't, perceives things differently, and possesses the ability to analyse the value, he/she stands a better chance of investing profitably. Value is best when it's analytical and based on solid facts. This will help an investor recognize when he can sell or buy stocks.

“I will tell you how to become rich. Close the doors.
Be fearful when others are greedy.
Be greedy when others are fearful”

- Warren Buffet

Thinking, Fast and Slow

Author: Daniel Kahneman

Thinking, Fast and Slow by Daniel Kahneman (winner of the Nobel Prize) gives a detailed explanation of some very simple yet basic concepts with far-reaching results. This book will make you realise that you are not as free in your decision making as you think you are. Working on your subconscious, this book has the power to make a direct impact on your conscious thoughts thereby changing your perspective and altering the way you think. This book is aimed at helping you easily comprehend critical thinking processes like judgmental errors, decision making, perception, analytical thinking, and irrationality. The crux of this book is our intuition or 6th sense, as it is commonly called. Many times we tend to assume things without giving any proper thought to it or applying any logic or reasoning. Kahneman talks about mental processes using the terms System 1 and 2, which according to him, produce fast and slow thinking simultaneously. At large, the book deals with System 1 and its influences on System 2.

Key Takeaways

1. How does the human mind make decisions?
2. When do we take impulsive decisions and when do we indulge in deep thought before making decisions?
3. Why does advertising work in terms of getting us to buy things or services?
4. Why do we remember only painful memories, and forget the happy ones?
5. How the human thinking process determines effective business models?

The two players inside our mind: Systems 1 & 2

A human mind can be divided into two major parts- System 1 and System 2. Though these terms are used in psychological studies, this book attempts to delve deeper into the subject and present the same as if they are two characters who are interacting with each other.

- System 1 is a quick and intuitive operator and has almost zero control, making its action automatic.
- System 2 concentrates on activities that demand attention, including analysis and calculations. This is also the system which deals with decision making in an individual's life.

System 1 is largely responsible for the subconscious mind, leading to the creation of what is otherwise called as the “gut” or “instinct”. There are instances where it can go wrong, but the fact that it can operate without much effort is a huge advantage. System 2, on the other hand, is responsible for analysis-driven decision making. Unlike going by intuition, System 2 needs a lot of effort to conclude things.

I can answer that in a second! But why?

At a glance, it does seem that System 2 is the core of it all. However, System 1 is where the main action is. While System 1 throws up complex ideas, System 2 ensures the orderly steps leading to it. A simple basic action like completing the sentence “Bread and --------“requires almost no effort on your part. This is something you can answer even in your sleep. On listening to loud music all of a sudden, your first action is invariably to try and find the source of the sound (System 1). Though a little while later, you consciously ignore the sound and proceed ahead with your work. The ignoring of the loud music is an action executed by System 2. The fill in the blank of "bread and butter" is an automatic task being done by System 1. But something as simple as giving your telephone number to someone cannot be done without System 2, as it requires attention to the task.

Why are some decisions taken from the gut?

Surprisingly enough, System 2 has the capacity to alter the functionalities of System 1. Multitasking is possible only if all, or at least a few, of those tasks are easily doable and do not demand your complete attention at any point in time. Whenever our mind is given a set of instructions to follow, we tend to set System 1 to work on it. Typically called being blind to the obvious, it emphasizes that we don't even realize when we turn a blind eye and to what. System 1 is where the belief of "feeling right" is born, which is not necessarily right. It could be over-confidence or just plain simple ignorance of many other existent factors. We need System 2 to help us take a rational decision.

How do the two systems work with each other?

System 2 is activated whenever System 1 finds itself in a situation which is beyond its call of "automatic" duty- like solving some difficult problems which might involve calculations or damage control. System 2 can also be called the monitor of System 1, responsible for the alertness while driving at night or asking us to be polite when we are angry. System 2 tries to curb the impulsiveness of System 1. Attention & effort go hand in hand, one often overriding the other, leading to relative decision making. In absence of rationality, the human mind tends to rely on intuition and believes it to be the ultimate truth.

Why are we seduced by advertising?

We tend to judge a person socially basis two things- One our own judgment in the initial meeting and two, the views of a person close to us who knows the other person as well. People tend to draw conclusions basis the skills and virtues listed by others rather than factors like luck and other things at work. When listening to a particular incident, we tend to interpret it basis System 1. However, when we retell the same incident to others, it takes our voice and has our thoughts strewn across the incident, rather than a faithful narration of the incident. In case we have played a role in that incident, it is possible we might portray ourselves much different than what we are in real life, and in most of the cases, a far better version of us.

Advertising targets System 1

If we want to impress someone by drawing his or her attention, we need to do so in a way that will directly put their System 1 into action, and make them reach a conclusion long before their System 2 can come into the picture. We normally do these using attractive fonts, rhyming lines and other such ideas to grab their attention,

something popularly known as advertising. Every time we say no to easy money via betting or gambling, System 1 is at play because it is ingrained in our values that gambling is bad. But we can actually push ourselves to activate System 2 so that it analyses the pluses and the minuses before concluding on what to gamble on. If done in the right fashion, this "calculated risk" can end up reaping huge benefits for us.

Why does losing hurt?

A difficult economics concept like the Prospect Theory can essentially be explained in simple terms as follows:
1. The pain of losing Rs. 10 is larger if you have only Rs. 20 with you, as compared to when you have Rs. 100 with you.
2. The pleasure or pain of a gain or loss is proportionately connected to the amount of wealth one has. If you have Rs one million in your account, a loss of a few thousand is acceptable, while a loss running into lakhs is considered scary.
3. Losing money is considered derogatory, irrespective of the amount both in hand and in losses.

Why making well-informed decisions is important?

Taking decisions in isolation is perhaps one of the gravest mistakes that can be committed. Even in criminal cases, the judges, before sentencing, take a lot of factors under consideration like the circumstances in which the crime was done, the background of the criminal, heat of the moment crime or crime with a purpose etc. Anything observed in isolation often leads to incorrect decision making as there are a lot of factors that have not been considered and hence gives us a one sided perspective, which is flawed. Our mind responds to problems basis the way they are formed. Because System 2 is lazy, it won't give much thought to process the information given before reaching a conclusion.

Do you remember the picnic or the flat tyre?

The duration of an experience plays almost no role in creating an impact on either of the systems. Instead, what is important is the feeling that it invokes-leading to imprints on the systems. If I am out for a picnic and have enjoyed the whole day, but in the end came back with a flat tire- making me push the car for quite a distance- **I would choose to remember the picnic bitterly rather than smile thinking about the fun I had during the day.** The next time I plan a picnic, I will be more cautious about my planning, especially when it comes to the vehicle that I will use to go to the picnic. This is where System 2 becomes active as it stores such memories and thereby gives birth to a certain set of fears and beliefs.

Why do we doubt happiness?

Human lives are largely defined by experiences and incidents. Surprisingly enough, we tend to remember all the emotions we felt during those incidents or experiences and not just the conclusion. If it had a happy ending, the jubilation would be occupying a very small part of our System 1 but the feelings that those moments evoked would be etched very deeply in System 1. Whenever we tend to think about those moments, our mind invariably goes back to those feelings, and not the conclusion of it- triggering a plethora of emotions in System 1. When we don't pay attention to what we are doing and choose to go with the flow, we end up taking some very wrong decisions, as at that time we allow those emotions to rule our mind, and not System 2-which would have rather analyzed it in depth and in a better fashion.

Should you take quick decisions?

System 1 is not prone to doubt, and it believes without any logic or reasoning. Any ambiguity is suppressed by it unless there is something that comes across as immediately negative to the mind. And that is where System 2 comes into the picture, as it tends to doubt. But there are high chances that people tend to get overconfident believing that their intuition not only works very strongly but correctly too. Anyone depending on such decisions and executing them is taking huge risks. You are highly prone to make miscalculations, leading to incorrect decisions when it involves huge risks. But share brokers, bankers and other such people who have to take such decisions day in and day out get used to switching off that side of their mind and heavily rely on System 1 to make such decisions.

How human psychology helps build business models?

Analyzing the above we can conclude how these studies have directly or indirectly laid the foundation of insurance and banking sectors, paving way for the financial structure of our society today. The core of every framework hence becomes human psychology and heavily involves our beliefs and emotions. Just like the law of diminishing need works on the first morsel of food consumed leading to satisfaction, it also works on materialistic things we gather. This is true for the single yet firm belief that the future is promising, as well. **What looks very dependable for a moment changes into a doubtful thing right after someone is successful in triggering our System 2 and putting it on active mode.**

Being deliberate in our decision making is an important human ability. Knowing that the System 2 is behind this thinking process further makes us aware of System 2. However, imagine if every decision requires System 2 to come into play? What if we think every time before we take a breath? The world requires us to use both Systems 1&2.

What we should aim at is applying System 2 to decision making that requires deep analysis. Otherwise we will be in a perennial 'analysis-paralysis' mode.

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“If you buy things you do not need,
soon you will have to sell things you need”

- Warren Buffet

This handcrafted book summary will help you learn

· Why amateur investors like you have a higher chance of success compared to professional investors?
· Why stocks should be picked basis the story of the company?
· How to discover the personality of a company, whose stock you want to buy?
· How to build a portfolio using the story behind opportunity companies?

Old is gold

I believe that investing is about believing in fundamentals that are as old as time itself. It is not about buying stocks; it is about buying a stake in a successful company via the shares route. It is also about patience- in my portfolio, the big winners take about 3-10 years to prove that they are the big winners.

The amateur is the winner

Do you see stocks as a complex instrument that needs expert views for you to decide which stocks to buy? You are wrong. The first rule in my investment philosophy is to stop listening to experts. The amateur investor is always better placed to win in the stock market if she sticks to the underlying fundamentals.

If you see Dunkin' Donuts open a couple of new restaurants in your area, it means that Dunkin' Donuts is growing. You do not need a high flying investment analyst to tell you that Dunkin' Donuts is doing well. This is common knowledge. The power of common knowledge is the only thing that the amateur investor needs to pick the right companies, and therefore, the right stocks.

Stock picking is an art

When I lost my father at the age of ten, I decided to support my mother by working part-time. As an 11 years old caddy, my education in stocks happened on the golf course. I continued being a caddy all through high school and college and absorbed all the discussions that happened on the golf course, while the movers and shakers played golf. In college, I decided to focus on arts and picked subjects like psychology, logic, epistemology and history.

I firmly believe that picking stocks is an art, and the only math you need to succeed in stock markets is primary school math. In 1963, I bought my first share (Flying Tiger Airlines) while still in college. I had done my research on Flying Tiger Airline before buying its shares, and within two years, I made a five-fold return on it, which partially funded my education at Wharton. At the Graduate School in Wharton, I got to do an internship with Fidelity and then joined the army, which took me to Korea. After my army stint, I joined Fidelity as a research analyst.

Before you begin buying stocks

When any of us first starts thinking of investing in stocks, we get the usual warning from friends and well-wishers- 'Stocks are risky. Stay with bonds (or debt)'. Yes, stocks are riskier, but stocks are about growth, while bonds are about the lending interest rate. That's a big difference. When picked with proper research, your stocks portfolio will, amidst all the uncertainties, reward you for backing growth.

But before you start buying stocks, think through these three questions:

Q1: Do I own a house?

It is vital that you buy a house before you buy stocks. Buying a house helps you understand the research that you need to buy stocks. When you buy a house, you do not go by speculation or news reports. Before buying the house, you visit the house, check every nook, and check plumbing and the schools in the neighbourhood, among many more checks. This is the common knowledge research that you need to do for picking stocks. Why should your checklist while buying a house become irrelevant when you buy stocks?

Q2: Do I need the money?

The risk in stocks gets magnified depending on what you need money for, in terms of life goals. If most of your savings will be spent on your child's college in the next 2-3 years, then stocks are not the right option for you. The mantra is to invest a portion of your money that does not hurt you, in terms of meeting your life goals.

Q3: Do I have the quality that will make me successful in stocks?

You need to have a couple of qualities to succeed as a stock picker, including patience, tolerance for uncertainty, and willingness to do research. Being emotional and trusting your 'gut instincts' is not what helps in the stock market. The willingness to stay invested in your stocks, despite negative market emotion (as long as the stock fundamentals are in place) defines your success in the stock market.

Do you have the edge?

As an amateur investor looking for the right company to buy shares in, you will get an opportunity in your own area, at least 2-3 times a year. It is essential for you to look for opportunities in the space that you understand well, and are comfortable in.

Doctors, who are looking for investment opportunities, should be interested in medical and pharma companies. That's because doctors prescribe medicines all through their day. But my instinct tells me that if there were a survey among doctors who are also investors, you would discover that doctors are more invested in oil stocks than medical stocks.

What is your edge? What space do you understand well? Pick stocks when you have the edge. This edge can be a professional advantage like the doctor example, or it can be a consumer's edge, where you are able to spot an opportunity just because you were observant enough while doing your weekly shopping or dining at a neighbourhood retail store or restaurant. The Dunkin' Donut example we discussed earlier is an example of consumer's edge.

What's the story behind your opportunity company?

Once you have identified the opportunity stock with your professional or consumer's edge, it is time to do some research. Here are a few questions to begin your research:

1. Did you identify the opportunity company because one product of that company is doing well? In that case, dive deep to figure out what impact the success of that product will have on the overall company results?

2. How big is the opportunity company? In general, you will have higher returns when you invest in smaller opportunity companies. Large companies like Coca-Cola in your portfolio bring comfort and stability, but their growth will also not be a multiplier in a short time span.

3. What category does the opportunity company fall in? I find these six categories useful for evaluating opportunity companies:

a. The slow growers: These are companies that have matured and offer no sharp growth peaks, but do offer a generous and regular dividend. In my portfolio, there's very little space for these slow growers. They typically show 4-6 percent annual growth

b. The stalwarts: Stalwarts are big companies that are growing faster than the slow growers. They typically show 10-12 percent annual growth in earnings. I have stalwarts in my portfolio because they stay stable during recessions.

c. The fast growers: These are aggressive new companies that grow at 20-25 percent annually. While these opportunity companies may be in fast growth category, there are examples of fast growers like Anheuser-Busch in a slow growth category like beer.

d. The cyclicals: In these companies, sales and profits rise and fall in regular time intervals. There may not always be predictability, but there is an 'up and down' pattern. These are the most misunderstood opportunity companies and typically confused with 'stalwarts'. The timing of your entry is critical for you to make money here.

e. The turnarounds: These are companies that have gone the wrong way, so much so that their stock is entirely discounted. And then a turnaround happens. There are examples where investors have made 32 times returns by picking up stocks of a battered company, which then turned around.

f. The asset plays: These are opportunity companies that have a valuable asset, which most investors have overlooked. This valuable asset could be the real estate of a company that is not doing very well. The land value of its real estate might turn out to be more valuable than the company's business operations.

Your opportunity company has a personality

Is there a perfect opportunity company? The answer may not be a definite yes, but there are these characteristics that define a perfect company:

1. The company operates in a non-glamorous and dull business, or has a 'dull name'. Being in a dull business keeps the crowd away, till the 'surprisingly good' results are delivered. By which time you would have made your money and sold your shares to 'trend followers'.

2. The company deals with something that is conventionally considered 'disagreeable'. The 'disagreeable' business can be about cleaning, washing, dealing with waste or something depressing like funeral homes.

3. The company is a spin-off of a larger and very successful organisation. Such spin-offs come with strong balance sheets, thanks to their parent companies, and the parent company wants to ensure that the spin-off company succeeds.

4. Typically analysts do not follow this company, and it is below the radar for most professional investors and experts.

5. The company is operating and growing, in a no-growth industry. It gets even better if this company is operating in a niche space.

6. The company makes products that people need to keep buying regularly. A toy company sells a blockbuster toy only once during the festive season, but a razor company sells razor blades every day.

7. The company's management is buying stocks, or even better, the company is buying back shares. When insiders buy, it shows high confidence in the company's short-term results. Additionally, when the management owns stock, then rewarding shareholders by delivering results becomes a more significant priority, rather than increasing top leadership team's salaries. Buying back shares increase the earnings per share as the number of shares in circulation goes down.

Stay away from 'hot picks'

I believe that the stocks I need to avoid buying are the ones that the rest of the investor community is chasing-the so-called 'hot stocks'. These 'hot stocks' have a very high probability of going the 'sizzle to fizzle' route. Yet another category of stocks that I avoid buying is 'the next----' company. There are companies who have seen their stocks rally up because they were the 'next McDonalds' or the 'next IBM'.

I shun companies that are diversifying, or as I call it, 'diworsefying'. In their attempt to grow, these companies acquire other expensive companies, and then invariably, sell or 'restructure' by selling these acquisitions at a loss. Additionally, companies that rely heavily on one single customer are probably not recommended for your portfolio.

Look under the engine

Having decided which company stocks you want to pick, the next step is to look at the fundamentals of the stock. There are three metrics that you need to look through in detail:

1. The earnings line: For all stocks, the charts show a stock price line and an earnings line. Typically, the two lines will move in close proximity. Even if the stock price line moves away from the earnings line, it eventually comes back to move in tandem.

2. The P/E ratio: The P/E ratio or the price/earnings ratio is another way to quickly gauge the relationship between stock price and earnings of the company. The P/E ratio helps you understand whether the stock is overpriced, undervalued or reasonably priced, in context of the company's ability to make money.

3. Future earnings: I suggest you do not try to predict the future earnings of the company. There are too many assumptions that professional investors build into their 'future earnings analysis' and despite their rigorous number crunching, these experts are 'surprised' when the company declares actual results.

Instead of trying to predict future earnings, you should focus on finding out how the company plans to grow its earnings. A company grows its earnings by reducing costs, raising prices, entering new markets, selling more in existing markets or by closing down loss-making business. You should find out which routes your opportunity company is planning on taking for growing its earnings.

The two minute explainer

Finally, after following all the above steps, there's one more thing you should do before you buy the opportunity company stock. Prepare a two-minute response to the following questions:

1. Why am I interested in this company?

2. In order to succeed, what does the company need to get done?

3. What are the obstacles in the path of getting things done for this company?
Answering these questions will help you have clarity about why you are buying what you are buying. Equally important, the answers to the above questions will be different for stalwarts, fast growers, turnarounds and so on.

Building the right portfolio

Your stock portfolio should always outperform your savings account return. But by what margin? The long-term return on stock markets is about 9-10%, which is higher than 4-6% return on bonds or lower in case of savings accounts. But when you make the effort of researching your stock and spending time on picking the perfect opportunity company, you should be able to generate a 12-15 % return on your stocks portfolio. The question, then is, how do you design a portfolio that generates a 12-15% annual return? And, how many stocks should feature in your portfolio?

The answer to the second question is more straightforward. You should hold as many stocks in your portfolio as you have the 'edge'; or you have unearthed a new stock that meets all the research tips we discussed earlier, including the two-minute response.

To answer the first question, How do you design a portfolio that generates 12-15% returns, you need to go back to the six categories of opportunity companies that we discussed earlier. You will need to build the portfolio keeping mind the stability benefits of stalwarts and slow growers, and the high growth benefits of the fast growers and turnarounds.

When do you sell?

Should you sell your winners when they are up, and hold on to your losers? Or should you sell your losers, and hold on to your winners for further gains. Both these selling strategies are flawed because the assumption is that the current stock price is linked to the fundamental value of the company. The reality is that the current stock price may not always reflect the actual value of the company.

A better selling strategy is to go back to our six types of companies. Build your selling approach basis the type of company- if the stock is a stalwart and it has gone to a certain outlier level, then it is time to sell. In case of fast grower, as long as the growth is fast paced, stay invested. In the case of cyclicals, sell if the current price is high and your research shows that company fundamentals are not in good shape.

In conclusion

At some stage in the near future, markets will decline. These declines are the time to go fishing for opportunities in the stock market. Patience and fundamentals research are big virtues in the stock market. Listening to gossip and expert views, coupled with esoteric analyses, will not help you.

This book by master investor Peter Lynch was first published in 1989, and then revised in 2000. While some of the examples in this book are dated now, the principles of investing detailed by Peter Lynch hold true as much today, as they did 30 years ago. You are encouraged to buy the book to go through the detailed number crunching that the author demonstrates as part of examples in the book.

“Never test the depth of the river with both of your feet”

- Warren Buffet

This handcrafted book summary will help you learn

- How you can be your worst enemy when it comes to investing
- What are the various human biases that trip you when investing?
- What is the best investment strategy?
- How to spot a bubble (and avoid it)?

In *The Little Book of Behavioural Investing*, expert James Montier takes you through some of the most important behavioural challenges faced by investors. Montier reveals that the most common psychological barriers, clearly showing how emotion, overconfidence, and a multitude of other behavioural traits, can affect investment decision–making.

Bias, emotion, and overconfidence are just three of the many behavioural traits that can lead investors to lose money or achieve lower returns. Behavioural finance, which recognizes that there is a psychological element to all investor decision–making, can help you overcome this obstacle.

There's no winter coming...

Humans are inherently optimistic. We hold an extremely high belief in ourselves- as students or as professionals, and as investors. An illusion of control further complicates this elevated sense of self.
It has been found that people are willing to pay four times the price of a lottery ticket when given the flexibility of choosing the numbers in the ticket. From a mathematical probability perspective, nothing much has changed. However, the illusion of control provided by 'selecting the numbers' makes the lottery ticket buyer think that he has a higher chance of winning because he (or she) can personally select the numbers in the ticket.

Quiz Time

Let's begin with a quiz question: *'A bat and a ball together cost $1.10 in total. The bat costs a dollar more than the ball. How much does the ball cost?'*

What is your answer?

Did you answer $0.10? Or did you figure out the correct answer, which is $0.05? This question is one of the three questions asked in the Cognitive Reflection test, which is considered more difficult than most IQ or SAT tests. Why do most of us see this question as a simple question and jump to the (wrong) answer of $0.10? Why do we jump to conclusions, when spending a few seconds thinking through would lead us to the correct answer? **This has got to do with how our brain thinks. This is the X system of information processing that the brain indulges in.** X system is the brain's default mode of operation. The X system comes into play automatically and without much effort and is often behind our emotional responses.

If you took some time and answered the bat and ball question as $0.05, you held back your default X thinking system and got the C system to work for you. **The C system of the brain is the logical system. It requires more deliberate effort to get the C system to work for you.** In trying to think logically, the C system gets slowed down and therefore is slower as compared to the default X system.

Is optimism a good investment strategy?

Our high sense of self-esteem and optimism is the X system at work. The X system of thinking dates back to our ancestors when life was more difficult in terms of risk to life. Optimism was a survival strategy for our ancestors. However, optimism is not a good strategy for modern day investors.

In fact, **over-optimism is a bane for investors.** Being sceptical and questioning optimistic scenarios is possibly the best investment strategy. Indeed, the best investors ask themselves *'Why should I own this stock?' rather than 'Why shouldn't I own this stock?'*

Procrastination & the investor

Empathy gap is defined as the inability to predict our behaviour in the future, when we may be under emotional stress. The familiar feeling that you will never eat so much again, after an unusually heavy meal, is an example of an empathy gap. Having overeaten then, you feel that you will never overeat again in the future. A resolve that gets broken the next time you are starving, and there is a delicious spread laid out for you.

Procrastination is the most significant reason for empathy gaps. When the deadline is far away, you are unable to predict how you will do your project at the last moment. Moreover, that is precisely what most of us end up doing-finishing our work under extreme stress at the last minute, thereby turning in suboptimal quality work.

In the world of investments, this translates into making errors in investment decisions, which can then lead to massive losses for you and your customers.

The solution to this lies in what is known as *pre-commitment*. For investors, this translates into two steps:

- Plan your investment when you are not agitated or when the markets are not volatile
- Pre-commit yourself to the action points devised using the planning step above

As Sir John Templeton said *'The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell'.*

In March 2009, the S&P 500 was down by 57% from its peak level in 2007. In such a doomsday type scenario, *terminal paralysis* sets in the markets. People hold on to their cash while those over-invested in the market freeze. The only way to overcome *terminal paralysis* is to stick to your pre-committed plan that you devised when things were *'normal'.*

Trust me, I am an expert!

Like optimism, **investors should be aware of experts**. Humans tend to confuse confidence with skill. The general belief is that if someone is extremely confident, he or she must be good! Moreover, it has been proven in psychology studies that experts are more overconfident than the rest of us.

In a group of weathermen and doctors, the weathermen turned out to be more confident of their predictions- when the weathermen predict they will be right 50% of the time, they were. However, doctors in such studies predicted that they would be right 90% of the time, only to find that they were right just 15% of the time. **This disparity happens because we prefer doctors who are confident, thereby egging doctors to be more confident than they are.** Will we go to a doctor who is not sure of his diagnosis? Probably not.

I predict a five-fold return on your money

So, are fund managers weathermen or doctors? Unfortunately, it turns out that fund managers leave doctors far behind when it comes to demonstrating overconfidence in their predictions. **Indeed, the illusion of being an 'expert' drives their overconfidence, which others confuse with skill, thus believing in experts.** This gets further complicated when you add the 'ability to forecast' to the 'expertise' of these experts. It is safe to assume with a certain level of confidence that forecasting is more about overconfidence than a genuine skill set.

Predicting the future in the world of investment is *'sheer madness.'* If forecasting is of no practical use, then why do we keep doing forecasts? In one of the most exhaustive studies done on forecasting, Philip Tetlock found that across a wide range of forecasts, **the experts were marginally better than someone who can make forecasts using just the toss of a coin.** In such scenario, why should we depend on forecasting? Moreover, by the way, isn't Discounted Cash Flow (DCF) a forecasting method?

Is DCF a wrong analysis tool then?

The answer is that there are better methods than DCF. The reverse-engineered DCF where instead of forecasting the future, you take the current market price and understand what it implies for future growth, is a better method. Another alternative is the Greenwald Approach that compares asset value to earnings power value and then builds a view of the intrinsic value.

The third option to standard DCF is what Howard Marks of Oaktree Capital believes *in-instead of predicting cycles, prepare for them, not in the context of predicting(or forecasting) the cycle but understanding your present position in the context of the cycle, i.e. knowing where you are in the cycle.*

Our analysis captures million data points!

Does more information lead to better investment decisions? To rephrase, does the adage less is more hold for the world of investment decisions? **Studies have shown that decisions are taken faster and more accurately when a**

lesser amount of information is available. Having more information just increases the confidence of the decision maker and confidence, as we saw earlier, can often be mistaken for skills.

As investors, it is essential to separate the signal from the noise. The leading expert in separating signal from the noise is **Warren Buffet**. Buffet does not look into in-depth data analysis of the next quarter projections. Instead, he looks for underlying economic and financial fundamentals when evaluating an investment decision.

In all likelihood, valuation of a stock, its balance sheet and the discipline of the board managing the cash on behalf of the stock are good enough for most investment decisions. **You might not feel confident making decisions with just these three parameters, but that is what information overload does to you- it makes you feel confident when you should not be.** TV analysts thrive on confidence perpetuated by an information overload. Not peeking into the TV screen or your Bloomberg terminal may be a wise investment decision.

Surprise me because I hate shocks

Confirmation bias is another enemy of making rational investment decisions. Confirmation bias is about selectively looking for information that supports our views or beliefs. Excellent fund managers or investment analysts will consciously look for evidence or information that proves their analysis wrong. Remember *'Why should I buy this stock' vs 'Why shouldn't I buy this stock?'*

Bruce Berkowitz of Fairholme Capital Management says he 'tries to kill the company' when he evaluates it for investment. Instead of looking for information that supports the investment decision, Berkowitz and his team do the exact opposite. They look for information on what would make the company collapse. Berkowitz makes extraordinary effort to be surprised by the upside rather than shocked by the downside.

But I have put so much money in this!

A good practice followed by most successful investors is to revisit their investment decisions at regular intervals, and make changes (including a complete write-off, if needed) when necessary. **A trap that the not so successful investors fall into is the *'sunk cost'* fallacy,** which makes them stick to an earlier position or decision simply because a lot of time and money has been invested into that decision. Being a permanent bear or a permanent bull is about falling into the *'sunk cost fallacy'* trap.

I am hopeful this scrip will grow

As we saw earlier, optimism (or hope) is the survival strategy for humans from the cave-man days. However, optimism is not necessarily good when applied to investment decisions, and can be utterly disastrous if as an investor, you are paying a premium for the hope of growth of the stock.

Paying a premium for the hope of growth is a mistake often committed when an Initial Public Offering (IPO) rolls out. Research indicates that in the US, the average IPO has underperformed the market by 21% in the first three years of the IPO rolling out.

Should you, then, believe in hope as an investment strategy? What is the recommendation then? As an investor, go back to the basics, stick to facts, and let your brain do the hard work of the C system. That is what **Ben Graham** suggested in 1934, and it holds true even today.

Wow, it's a bubble!

A bubble, in its strictest sense, is defined as price movement that is at least two standard deviations from the trend. Statistically, as per the efficient markets hypothesis, this should happen every 44 years. However, there have been more than 30 bubbles since 1925! **How can we, then, believe that markets are efficient?**

Bubbles are actually *'predictable surprises'* that explode into a crisis, because the few people who were aware of the problems that led to the bubble, did not act on it. For every bubble, there is always a set of people who caution against the bubble. However, **the challenge is not in predicting the bubble, but in predicting the timing of when the bubble will burst** and become a crisis. Hence, the term predictable surprise. People predict a bubble but are surprised by the timing of the bubble burst.

I was sure this bubble will not burst

So why are we unable to tackle these predictable surprises well in time? There are five reasons behind this behaviour:

1. The over-optimism that we discussed earlier. We believe in looking at the bright side- others get divorced, I do not. ***Similarly, others get caught in a bubble burst; I will not.***
2. The illusion of control that we carry within ourselves. TV channels churn out analysis that makes us believe that we have quantified the risk and therefore things are well within control. Only to get a nasty surprise later.
3. The self-serving and self-confirmation bias that makes us believe only in information that meets our interests. **As Warren Buffet said *'Never ask a barber if you need a haircut.'***
4. We prefer spending more time making choices that are geared towards the short term. When we make a decision that will bear result only in the future, we do not put too much of thought into it. However, when we make a decision where the consequences are in the near future, maybe next week, we think through our choices with much more thought.
5. Finally, we miss spotting the bubble because we are not looking for it! We are so enthralled by the bubble that we are not looking at the evidence of it bursting anytime soon. Behavioural economics terms this as **inattentional blindness.**

The four most dangerous words in investing

Experts in the analysis of bubbles believe that an 1867 paper by John Stuart Mill is the best framework to understand a bubble. The bubble framework based on Mill's paper captures the five stages of a bubble:

1. Displacement: This is the creation of profit opportunity, which though slow in the pace of growth, is the first stage of a bubble creation. The slow growth makes most people miss it, but there are a few early spotters who have got in at this stage of the bubble

2. Credit creation: Credit creation acts like oxygen for the bubble.The credit required to 'nurture' the bubble can come from various sources including money from banks, the creation of new credit instruments or scaling up of non-bank credit.

3. Euphoria: This is where over-optimism comes in to make the bubble bigger. At this stage, nothing about the bubble is wrong. All the behavioural economics concepts of optimism, self-serving bias, myopia and inattentional blindness start manifesting themselves at scale. The common belief, as Sir John Templeton said, is 'This time is different'. Those are the most dangerous four words in investing.

4. Financial distress: This is the stage where the people who are aware of the problems behind the bubble, the insiders, start cashing out. Instances of fraud emerge, and the excessive leverage built during the earlier phases of the bubble leads to a crisis.

5. Revulsion: the final stage in the life of a bubble is where scarred investors decide to exit the bubble sector, or the market completely. This leads to a crash and resultant bargain price for the assets involved in the bubble. As Mill wrote 'Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works'.

Bubbles are formed due to human behaviour, and the good news is that human behaviour is predictable.

Don't move!

In the 1950s & 1960s, the average holding period of stocks by investors was about 7-8 years. However, today, the average stock holding period on the NYSE is just six months. Being myopic and thinking only for the short term is a malaise in the investing world today. **In addition to this myopia, things get complicated by the need to keep showing that the fund manager is not sitting idle. Instead, she or he is busy taking steps to help your money grow.**

In reality, the best thing to be done is to leave the portfolio alone. We see action bias as a positive thing. Research has shown that during penalty shoot-outs in soccer, the goalkeeper would have saved more goals by standing still at the centre of the goal, instead of jumping left or right. Yet, the goalkeeper is expected to *show action by jumping left or right.*

What should the investor do instead? **The opposite of action bias is not inaction, but patience.** Patience and discipline are the best friends of an investor. Traders believe in action bias, investors believe in patience and discipline.

Walk the path alone

Neuroscientists have found that there is fear and pain associated with the thought of going against the crowd. Brain scans show that when the thought of going against the crowd crops up, the amygdala portion of the brain becomes active. Amygdala is the part of the brain that processes emotions and fear. Being contrarian requires you to activate your brain's C-system, which requires much deliberate effort.

The contrarian investor

As a contrarian investor, you go against the crowd. **When others buy, you sell. When others sell, you buy**. A note of caution is required here- due to our high sense of self-esteem and optimism, we all believe that we are the contrarians, and others conform to the herd. More often than not, we are mistaken and this belief of being a contrarian when we are not comes from a lack of introspection of our actions. **Being a true contrarian in our lives, and as investors requires the following deliberate behaviour:**

- Demonstrate the courage to go against conventional wisdom and groupthink
- Practice critical and independent thinking before making choices, including your investment decisions
- Be disciplined enough to stick to the path of being a contrarian. Grit matters.

When do I sell?

The best way to decide when to sell is to stop focusing on the short-term. **The more you keep checking your portfolio, the more short-term loss scenarios will emerge, which will make you sell.** As human beings, we are averse to losses and like to cut our losses as much as possible. When you keep checking your portfolio, you end up looking at short-term losses, thereby succumbing to the need to cut your losses by selling. If you have done your research well, your portfolio should not require a second-by-second monitoring.

Researchers believe that the endowment effect plays a critical role on our decision to buy or sell. The endowment effect happens when you, as compared to others, attach a higher value to something that you own.

If you own a bottle of wine whose price has appreciated ten folds in the past few years, will you sell the wine bottle? The most common answer is a No. Will you now buy a similar wine bottle at ten times the price? The answer in most cases is, again, a No. This is the endowment effect in play. Reluctance to sell is a common behaviour of investors who are swayed by emotions and biases.

Focus on the process, not the result

The need to focus on the process rather than the result is the adage that successful investors should swear by. Too much focus on the results leads to sub-optimal choices on account of a desire to reduce losses and avoid ambiguity. **Instead, focusing on the process leads to better decisions, and higher long term returns.**

As Ben Graham said 'The value approach is inherently sound, devote yourself to that principle. Stick to it, and do not be led astray'. **The best investors in the world, including Warren Buffet, Bruce Berkowitz, John Templeton and many others have built their own processes or heuristics to arrive at a sound investment decision.** The only person standing between you and successful investment decisions is you, and your errors and biases.

Get your C-system to consciously think and avoid the biases.

“Rule #1: Never lose money; Rule #2: Don’t forget rule #1”

- Warren Buffet

The Black Swan:

Author: Nassim Nicholas Taleb

Edelweiss MUTUAL FUND
Ideas create, values protect
Insights
Book Summary

Taleb's "The Black Swan" is a treat for the reader and covers everything about probabilities, risks and human psychological biases. It is rich with research and peppered with clever analogies that makes the material relatable and interesting to read. At a time when our world is going through a black swan event in the shape of the coronavirus, this book can help individuals navigate volatility, avoid common mental pitfalls and become better, more rational thinkers.

Key Takeaways

- Many aspects of our lives are dominated by unlikely, large and unexpected events
- It is in the nature of humans to focus on the likely and probable
- We all see patterns and causality where, in reality, there is a lot of randomness
- This implies the need to use the extreme event as a starting point and not treat it as an exception to be pushed under the rug
- The past is not a reliable predictor of the future
- One should not waste their time trying to predict extreme events. Instead, one should adjust to the black swans
- Black swans can also be positive and offer huge opportunities
- In order to capitalise upon positive black swans, one must constantly be on the lookout for opportunities and should not hesitate to grab them
- You are the only one who can control your destiny. The way you react to an event will determine its impact on you. Take control of your life.

The Black Swan

Throughout history, there have been highly improbable events that catch almost everyone by surprise and can potentially have a large impact on status quo by disrupting human activities and/or creating havoc. Such kind of events are called Black Swans. The name stems from the fact that up until 1697, mankind believed that all swans were white. A belief that was completely confirmed by empirical evidence. However, eventually, Dutch explorers sighted black swans for the first time in Western Australia, completely nullifying the belief that swans can only be white. Thus, the term 'black swan' morphed into describing an event that occurred despite seeming impossible. The sighting of the black swan illustrated a severe limitation to our learnings from observations or experiences and the fragility of our knowledge. All you need is a single observation to invalidate a general belief derived from millennia of confirmatory evidence. Since black swan is the occurrence of a highly unexpected event, conversely, a highly expected event not happening is also a black swan.

For an event to be characterised as a black swan, it needs to have three characteristics:

1. It should be an outlier – the event should be unexpected ie., it should lie beyond the normal range of expectations because nothing in the past can convincingly point to the possibility of its occurrence
2. It should have a massive impact – in addition to being an outlier, the occurrence of the event should have a large impact on human kind, challenging status quo
3. Despite being accorded an outlier status, humans should be able to explain the occurrence of the event after it has happened ie., ex-post it should be explainable and predictable

The triplet to deem an event as a black swan is: rarity, extreme impact and retrospective predictability. It is interesting to note that a small number of black swans that have occurred throughout history can potentially explain almost everything in our world, from the success of great ideas, the spread of religion to various important elements of our own personal lives. The occurrence of black swan events has, in fact, been increasing at an accelerated pace and so has its potential impact.

Black swans are unpredictable not because they are random, but primarily because our outlook, knowledge or field of experience is too narrow to grasp the possibility that the improbable can also happen. Consequently, those individuals who are the least aware of a black swan coming will probably suffer the maximum from its already extreme consequences. As such, black swans cannot be measured. The immeasurability of black swans and the human tendency of discounting their very possibility contributes to its ability to make a large impact.

The field of finance regularly makes an attempt to capture outlier events and fails with equal regularity. Financial professionals use multiple models to capture uncertainty. However, as is evident from history, most portfolio and risk management models fail to capture black swans. A large portion of risk management professionals use the bell curve to understand the probability of risk. However, bell curves only measure the normal or the average occurrence, and tend to ignore the large deviations. When you measure averages, you run the risk of getting useless and dangerous information. If you cross a river that is, on average, 4 feet deep, you will likely drown. Thus, bell curves are ineffective in capturing the unexpected and potentially disastrous events. This is not just true for finance professionals. It is even true for organised sports, where following rules is imperative. Since athletes are trained to make certain moves they become weaker when faced with unexpected events.

For example, fighters train with certain rules which makes them more vulnerable in a street fight because they are not trained to expect illegal moves.

In real life, you don't know the odds. You need to discover them.

The past is never a reliable predictor of the future

One of the biggest errors that humans make while trying to predict the future is a proclivity to use data gleaned from the past to explain what might occur in the future. Based on things that have occurred in the past, we weave a narrative for the future that makes sense to us. Consequently, we expect the future to unfold accordingly and are completely taken by surprise when it does not. This is because there are many unknown factors that can impact our future.

Take the example of a turkey. Before Thanksgiving a turkey is fed every day. This firms up the bird's belief that it is the general rule of life to be fed and taken care of by the human race. The turkey starts believing that the humans will always look out for its best interest. As the number of feedings grow, it becomes more and more confident that it will be safe. However, on the Wednesday before Thanksgiving, the turkey will be on its way to the slaughter house. This will definitely take the turkey by surprise as he never expected the humans to kill it. The only reference point for the turkey's belief was his past experience with the humans which in no way indicated that they would harm it. On the other hand, while the turkey is surprised before Thanksgiving, the butcher is not. Which means that black swans are relative to your knowledge and expectations. What might be a black swan to some might be completely expected by others. In order to avoid situations where you can be fooled in a huge way, you must actively avoid depending on large and potentially harmful predictions.

Everyone loves a good story. When we look back at history, we tend to interpret it in such a way that it fits into a nice story. We try to make sense where there is none. We try to predict when in fact what actually happened might have been completely random and unplanned. We want to believe that there was a nice clear progression that is predictable and will thus carry into the future as well. The best way to avoid the traps of narrative fallacy is to eschew storytelling in favour of experimentation, history in favour of experience and theory in favour of knowledge.

Assessing real world risk

When faced with the task of assessing real world risk, we treat it as a risk game, assuming certain ground rules and probabilities that we can determine at the onset. This gives us the false sense that we know what is going to happen next and that the decision we are making is the right one. While it is hard for us to assess risk accurately in the real world, oversimplifying it can only make it worse.

For example, if you observe a coin flip game, where the dealer tells you the coin is fair (i.e. lands on heads or tails 50:50), but for 99 times in a row it comes up heads, would you really believe the odds are still 50:50 on the next toss?

Statistically speaking, the odds haven't changed, but any reasonable person would assume that the coin is rigged and bet heads.

So what should we do? How do we deal with black swans if we can never accurately predict them? The key is to focus on "anti-knowledge", or simply on the things that we do not know. Instead of naively trying to predict black swans, we should try to adjust to their existence. And when we adjust to them, we can position ourselves not only to limit the downsides, but also to take advantage of possibly positive black swans, called "serendipitous black swans".

Taking advantage of serendipity (positive Black Swans)

The payoff in a venture is generally inversely proportional to what it is expected to be. Thus, to become successful in a profession, it is important to do something beyond that which is currently within the realm of possibilities. Position yourself in an industry with small losses and huge wins, like venture capital, publishing, scientific research, or movies. These professions usually offer a disproportionate payoff from the unknown, since you typically have little to lose and plenty to gain from a rare event.

Do not rely on a top-down planning approach that narrows your thought process and encourages you to predict. Instead, focus on experimenting and recognising opportunities when they come your way. Seize any and every opportunity or anything that looks like an opportunity. Positive black swans can only benefit you if you are exposed to them. Work hard in chasing such opportunities and exposing yourself to them. Put yourself in situations where the favourable consequences are much greater than the negative ones. Not necessarily more likely, but more life changing. In general, positive black swans take time to show their effect while negative ones happen very quickly— it is much easier and much faster to destroy than to build.

The End

The best way that you can get the better of black swans is by simply snubbing them. It is inevitable that we get exposed to the improbable. We cannot control this. But what we can control is how we react to it. You can always control what you do. Focus on that. For example, missing a train is only painful if you run after it, if you allow yourself to care. If you simply shrugged it off and told yourself that you can just board the next one, you will not be impacted.

In Taleb's words, *"Quitting a high-paying position, if it is your decision, will seem a better payoff than the utility of the money involved (this may seem crazy, but I've tried it and it works). This is the first step toward the stoic's throwing a four-letter word at fate. You have far more control over your life if you decide on your criterion by yourself."*

"The Black Swan" tells us that extreme events will occur and will continue to impact us in myriad ways. Since such events cannot be predicted, it is important to adjust to them. As an investor, you can ensure that your portfolio can adjust to a black swan event by following the principles of portfolio diversification and asset allocation. By spreading your investments across multiple asset classes and uncorrelated investment products, you are ensuring that the impact of an extreme event is limited to only a certain part of your portfolio and not your entire portfolio. Mutual funds can be an ideal investment vehicle for achieving optimal portfolio diversification. Mutual funds offer multiple schemes that invest in a variety of asset classes and offer varying levels of risk and return to an investor.

“Risk comes from not knowing what you are doing”

- Warren Buffet

The Millionaire Next Door

Author: Thomas Stanley and William Danko

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Ideas create, values protect

Insights

Book Summary

There must be hardly any person who is not interested in getting rich. We all want to know that one secret which all the rich, seem to share. In "The Millionaire Next Door" authors Thomas Stanley & William D. Danko examine the common characteristics of millionaires, debunk the myths associated with millionaires and provide a detailed perspective of what a real millionaire looks like. Using real-life data and examples, the book analyses the habits of the wealthy and wheedles out their common attributes, practices and ways of life. The book makes for an interesting read and sheds perspective on the lives of millionaires.

Key Takeaways

- To be considered a millionaire, as per Stanley and Danko's definition, you must be worth US$1million or more.
- Being a millionaire goes beyond "appearance". Millionaires may not seem 'wealthy' from the outside.
- Frugality is a common trait of millionaires.
- Millionaires learn how to be efficient and responsible with money.
- The first step towards accumulating true wealth is planning how to spend your money.
- As a wealthy parent, it is important that you take the time to consider how you raise your children. You want to encourage them to be responsible with money.
- Consider whether you are truly benefiting your children when you gift them money. And question if it is actually having a negative impact on their future capabilities.
- There is always going to be a difference between those who work hard for their wealth and those who are born with it.

What makes a Millionaire?

"These people cannot be millionaires! They don't look like millionaires, they don't dress like millionaires, they don't eat like millionaires, they don't act like millionaires—they don't even have millionaire names. Where are the millionaires who look like millionaires?"

Most people would consider, the number of material possessions that a person has, as a true measure of his or her wealth. Consequently, most people think that rich people have a lot of material possessions. However, to be a millionaire one does not need to have a plethora of material possessions. Wealthy people do not necessarily only place importance on the possessions that they own. They seldom make their wealth obvious. You may not be able to tell that they are wealthy by looking at the car that they drive, the clothes that they wear or the watch they have on their wrist.

"Those people whom we define as being wealthy get much more pleasure from owning substantial amounts of appreciable assets than from displaying a high-consumption lifestyle."

For the purpose of this book, Stanley and Danko consider the 'wealthy' to be anyone who has a net worth of one-million (US) dollars or more. A couple of facts to note when considering this figure is that only 3.5% of

American households can be considered wealthy by these standards and of that 3.5%, 95% of them will have a net worth anywhere between one-million and ten-million.

These figures will probably make you wonder why the book is focusing on such a small segment of the population. The reason that this particular segment of wealth has been chosen, is because it's entirely attainable, its reachable by many Americans and can be done in only one generation. It's not going to take time to build up to this level of wealth. They are the millionaires who live among us.

Frugality and Budgeting

A question plaguing many minds is, "why is only such a small percentage of the population considered wealthy." There are many households that earn a six-figure salary but have still not been able to reach the threshold. This is primarily because an alarmingly large number of Americans live their life spending tomorrows money. Many households in America are entirely debt-dependant. Living pay-check to pay-check, digging into savings and over-drafts.

"They are debt-prone and are on an earn-and-consume treadmills."

These are the people that spend their money on possessions that they believe will give them the wealthy image, possessions to essentially lift their 'success.' When in fact, the reality is that it's purchasing these very possessions, which is detrimental to their wealth. Millionaires, those who can be considered wealthy, always budget. The average lifestyle of the American millionaire is not what the public perceives it to be. The average millionaire is well into his fifties, has been married to the same woman, and lives in a middle-class neighbourhood. The average millionaire is more likely to buy a $40 pair of shoes than a $500 pair of shoes although he has the money. Another aspect of the millionaires in this country is their spouses. More often than not, the spouses of millionaires are more frugal than their counterparts. Most people will never become wealthy in one generation if they are married to people who are wasteful.

"They became millionaires by budgeting and controlling expenses, and they maintain their affluent status the same way."

When surveying the wealthy, it was discovered that most 'millionaires' had less than 7% of their total wealth as total annual realised income. The incredible result of this is that whatever the figure is under 7%, that's all that they have subject to income tax. To build wealth, minimize your realized (taxable) income and maximize your unrealized income (wealth/capital appreciation without a cash flow). Often, a household may be considered asset-poor, regardless of it's high income. The key reason that this happens is that they lead a high-consumption life, and in order to do this, they are required to maximise their realised income.

"Such people might wish to ask themselves a simple question: Could I live on the equivalent of 6.7 percent of my wealth? It takes much discipline to become affluent."

Planning& Frugality is the cornerstone to building wealth

The most common traits among the wealthy are efficiency and the ability to plan well. In order to become wealthy, people had to learn how to use their time, energy and money in the most efficient manner. Without efficiency, it would be a lot harder to accumulate any wealth. People who understand how to plan their wealth have the ability to set aside money for investments etc. A great goal to have is to have a minimum of 15% of your income available for investments. This is going to help set you up for more wealth.

Ask yourself how much your household spends in a year, and whether you know what portion of that spending comes out of different categories such as groceries, petrol, bills, mortgage etc. Unless you understand exactly how and where you are spending, it is almost impossible to truly control your money. If you can't control your money, it is not likely that you will ever accumulate a lot of wealth. The first step toward planning is to maintain a record of your expenditures and gains, to get a better understanding of where your money is coming from and where it is going. You can consider working with an accountant and come up with an achievable budget. Remember that knowledge is power.

Millionaires and their flashy cars – A myth

"If your goal is to become financially secure, you'll likely attain it. But if your motive is to make money to spend money on the good life, you're never going to make it."

Our research revealed some interesting facts about motor vehicle ownership among the wealthy.

1. Just over 1/4 of those surveyed had not purchased a car in over 4 years.
2. Just under 1/4 actually own brand new cars.
3. The remaining purchase second-hand or lease.

This debunks the myth of the wealthy only owning brand new, flashy, top of the range cars. You can be wealthy and still choose to own a standard second-hand car.

"Being frugal is a major reason why members of the used vehicle-prone group are wealthy. Being frugal provides them with a dollar base to invest."

Family forms an integral part of the millionaire's life. Children of the wealthy often become "high-volume consumers" but are seldom wealthy themselves. The children spend to increase their status, they purchase luxury cars, buy flashy homes in nice areas and send their children to expensive private schools. The term economic outpatient care (EOC) defines the economic presents that children receive from their wealthy parents (or even grandparents.)

"They are living example of one simple rule regarding EOC: It is much easier to spend other people's money than dollars that are self-generated."

It's common for those that receive EOC from their wealthy parents to become 'under-achievers.' They tend to earn less of their own money because they don't feel that they need to. It is also common for those who have received EOC to spend more than they earn. They find it harder to separate their earnings from the wealth of their parents, who perhaps gift them too much. They have a tendency to rely on credit and debt. And one of the most common traits amongst this group of people is that they always invest less than those who don't receive any Economic Outpatient Care.

Unfortunately, many wealthy parents see no harm in EOC. They believe that it can be beneficial. And in some circumstances, believe that it is correct. However, in order to be successful later in life, these children need to be disciplined. Parents need to instil in them the ability to earn a living and provide for themselves without relying on hand-outs. This becomes a problem when those receiving the EOC are indisciplined, irresponsible and have no means of earning their own money.

So, it's been made pretty clear that gifting your children money, which obviously feels like a nice and generous gesture, can often do them more harm than good. However, as a parent, you would like to provide them with something that will make them financially stable and responsible adults.

10 Rules for affluent parents raising productive children

- Don't let your children know how wealthy you are.
- Always focus on teaching discipline with money and the art of being frugal.
- Do your best to ensure that your children don't have a complete understanding of your wealth until they are mature, disciplined and in a working profession, providing for themselves.
- Don't discuss inheritance with your children.
- Don't use cash as part of a negotiation, especially with your adult children.
- Distance yourself from your child's family matters.
- Never see your children as competition.
- Remind yourself that each one of your children is their own individual, independent person.
- Always acknowledge your children's achievements, make them feel good about what they can achieve. Don't acknowledge or celebrate simple symbols of success.
- Ensure that your children understand that there is more to life than money. And show them that many things hold more value than money itself.

The Workforce

In the next ten years, there will be a growing amount of money in this country than ever before. Opportunities to serve the wealthy will be greater than ever before. Those who are specialists in meeting the demands and solving the problems of the wealthy will be in great demand. Specialists with the highest skills are more likely to benefit than those who don't have those skills. Specialists who will benefit include:

- Medical and dental care specialists
- Asset liquidators, facilitators and appraisers
- Educational institutions and professionals
- Professional services specialists

- Housing specialists/dwelling products/services
- Fund-raising counsellors
- Travel agents / consultants and bureaus

Get rid of the silver spoon and work hard instead

There really is no magic formula for accumulating wealth. While being self-employed can be a good first step, one must be cognisant of the fact that a majority of business owners actually never see their money accumulate into true wealth.

As a business owner, you will be aware of the success odds, you'll be aware of the competition, the vulnerability of trends and the unknown. And for this reason, less than one in five business owners, who can be considered wealthy, will leave their business to their children to run and own. In order to be a successful business owner, you have to have a real motivation to succeed. You need to want to be self-employed. Successful business owners need to love what they do and take pride in 'going at it alone.' If you're simply handed a business on a silver platter, you are unlikely to have the same drive and desire. It's likely the business will not continue to succeed in the same way.

Simply put, the majority of millionaires are actually modest, don't spend their money on things they don't need and adopt a common sense strategy to wealth building. That's how they became rich in the first place.

“Price is what you pay. Value is what you get”

- Warren Buffet

Nudge: Improving Decisions about Health, Wealth and Happiness is an eminently readable book on behavioural economics. The book talks about how people always go for the path of least resistance when it comes to making decisions. In order to help lazy decision makers pick the right choice, it is important to create nudges that help make them decisions that are beneficial.

The book is co-written by two authors. Richard H Thaler is an American economist who won the Nobel Prize in 2017. Cass R Sunstein is an American law expert and professor who was part of the Obama administration.

This handcrafted summary of Nudge will help you understand how people make decisions and how most of these decisions are not taken in a rational manner. In this context, it is important for nudges to guide people towards the right choices. This summary also helps you understand the various types of bias that seep into our decisions

Nudge is a fascinating book that simplifies concepts of behavioral economics and helps you understand the power of nudge using examples from the world of economics, finance,marketing, and even day to day life.

Are you free to choose?

Having a choice, gives a sense of freedom - The Freedom to Choose. While we like to believe that we are free to make our own choices, there is an influence that plays a role in making our choices.

These influences can be biases, recommendations, or even structured external 'interferences'. For a very long time, economists believed that people could make rational choices, **until behavioural economists proved that, more often than not, people do not make rational choices.**

Another fallacy about human behaviour is that people like to have more choices. **The more, the better.** However, the reality is that too many options or choices make it difficult to make up our mind. This happens because humans take decisions based on the two distinct systems.

Thinking, fast and slow

The human brain operates in ways that we do not yet understand completely. However, what we know is that our brain helps us make decisions in two ways or two systems:

The **automatic system** or the intuitive system provides emotional responses or automatic actions. If you know how to cycle, then getting on cycle and pedalling away is an **automatic decision,** because you are habituated to cycling.

The **reflective system,** on the other hand, is more deliberative and thinking oriented. If you do not know how to cycle, then learning to cycle is where the reflective system of the brain helps you. You put in all your focus and attention in learning the new skill, i.e. cycling. Once it becomes a habit, however, it then becomes a decision that is taken by the **automatic system.**

The reflective system is slow and thinking oriented (conscious thought), while the automatic system is quick and habit or instinct oriented (gut reaction).

It is too much of an effort

It takes a lot of effort to ask the **reflective system** to take a decision, so we naturally gravitate towards the **automatic system,** which does not require a lot of thinking or effort.

One 'hack' to take decisions on not-so-simple choices without making too much effort on the reflective system, is to use **thumb rules.** While rules of thumb help make quick decisions, they also carry biases that cloud decision making.

The biases that creep in

One such bias is **anchoring**. In anchoring, you use a familiar fact, or a 'reference point', to arrive at a decision, which might turn out to be a flawed decision. For example, a charity might ask you to donate one of the four amounts: $50, $75, $100, or $150. Your chosen donation amount will be one of these four options.

However, if the same charity asks you to pick a donation amount from options of $100, $250, $1000, or $5000; there is a higher probability that you will pay more than what you paid in the earlier options. This is because, in the second set of options, your choice was **anchored** to the higher amounts.

Similarly, there is the **availability** bias, where your choice of taking insurance against a natural disaster like an earthquake increases if you have experienced an earthquake.

The third bias is known as **representativeness** bias, where people judge a situation and make choices based on how similar that situation is to past experiences.

Another inherent bias in humans is **overconfidence** in one's ability. Similarly, many companies make money from the **status quo bias,** where you continue subscribing to a magazine or service, long after you have last used, just because you have not made an effort to look up and unsubscribe the service.

Context affects choices

People are busy, with limited attention span. We rely on thumb rules to make decisions, and thereby get into the biases trap, and end up, in most scenarios, making a flawed decision.

The choices we make, therefore, are and can be, influenced.

These influences are **nudges** that guide us towards a particular choice, from a set of options. When someone places a bowl of cashew nuts before you, you eat the cashews till the bowl is empty. If someone refills the bowl, you eat some more. However, if the bowl is not refilled, then you do not eat any more cashews.

This *mindless behaviour* is based on **inertia,** where the automatic system takes over, and you do not pay attention to what you are doing.

Framing is another way where you can be **nudged** into choosing different options in different scenarios. If you are told that surgery leads to the death of 10 out of 100 people, you will be worried about choosing the surgery option.

But if you are told that 90 out of 100 people survive the surgery, you are more likely to choose the surgery option.

Social influences also act as a **nudge,** when it comes to making a choice. Marketing folks have used this as a way to sell their products for a long time.

A lack of self-control, combined with mindless choosing, can lead to poor choices.

Why is making a choice so difficult?

What are the scenarios in which people need a **nudge** to make the right choice? There are various choice environments that make choosing the right option difficult for people.

One scenario is the ***- Benefits Now - Costs Later*** scenario. There are **investment goods, like exercising,** where the current cost regarding effort is very high, and the benefits are delayed in the future. Similarly, there are **sinful goods, like smoking,** where the current benefits are high, but the costs or consequences in future are dangerous.

Degrees of difficulty is yet another choice architecture scenario where making the right choice is difficult. Some choices, like deciding on a mortgage or a loan, are infinitely more difficult than deciding on which bread to buy.

This brings us to the **frequency** parameter in choice architecture. Choosing which bread to buy is a daily choice, so if you make the wrong choice, then you can always go back to your earlier choice the next time you buy bread.

Once-in-a-life difficult decisions

However, choosing a mortgage is an infrequent decision, maybe not more than two or three times in your life. The low frequency of choice and subsequent cost of the wrong choice makes choosing difficult in case of **once-in-a-life decisions.**

Lack of feedback, or delayed feedback, also makes choosing difficult. Similarly, the human brain processes choices differently as compared to experiences.

This is similar to being explained the choices of food in a menu, in a language that you are not familiar with. Choosing options from such a menu is difficult unless you experience what the chosen dish tastes like.

What is the choice architecture?

Choice architecture is about creating **nudges** that are most likely to benefit people and least likely to harm them. As a choice architect, you design the choice environments, and then design **nudges** that subtly, or not so subtly, nudge you towards the choice that is good for you.

A **nudge** needs to help make you the right choice when making a choice is difficult for most people. In order to do so, a choice architect needs to have a good understanding of how people behave.

Humans make mistakes and commit errors all the time. A choice architect needs to keep in mind this fact and ensure that **nudges** are built to help people avoid making such mistakes.

The alarm in cars that indicate that you are not belted when the car is in motion is an example of a nudge that prevents people from forgetting to snap on their seat belts.

The power of 'default option.'

A good choice architect can unleash the power of the default option. If we go back to the brain's **automatic system,** we recollect that people tend to be lazy and try and make choices using the automatic system instead of the **reflective system.**

This can lead to making the wrong choice. We tend to be comfortable with whatever default option that our computers or household goods come with. The path of least resistance is what people look for; default options, therefore, need to help make the better choice.

Other types of nudge

Providing immediate feedback is a good nudge. In the case of digital cameras, the ability of the camera to show what you just clicked is an example of immediate feedback nudging the user to make a better choice; in this case, a better image.

Explaining options so that they are understood in practical usage terms is another way to nudge people towards the right choice. This is called **mapping.** Continuing with our digital camera example, megapixels is a popular way to sell digital cameras.

Higher megapixels means better image resolution, but what it also means is more space as high megapixel images are heavier. Could the size of the image be a better way to explain megapixels option to the consumers, as the usage of an image is mostly regarding its size, and not resolution?

Incentives as a nudge

When we looked at biases at the beginning of this book summary, we saw that rules of thumb help simplify complex decisions.

A paint shop is an example of a **complex choice structure**. There are thousands of colour combinations that are possible by mixing shades. Using linear list based shade card will make choosing the right shade an extremely exhaustive exercise.

By clubbing colours in similar groups, the choice process becomes simpler as you first choose the main colour group and from thereon you move to specific shades within that colour group. This simplifies a complex choice structure.

Incentives are the most powerful nudge to get people to make a particular choice. A simple heuristic that can be used while designing an incentive as a **nudge** is:

1. Who uses?
2. Who chooses?
3. Who pays?
4. Who profits?

Nudges that help in saving money

When it comes to money, just like in other cases, humans do not make a rational choice. People end up making wrong choices, whether it is experimenting with bread or deciding to save money for a rainy day.

Can a **nudge** help people do a better job in choosing options in **saving, investing, and borrowing?**

The economic theory of saving for retirement is a simple concept but built with complex tools. The concept is that in the future when you retire, you need to have enough money to continue having the same lifestyle as you did when you had a salary coming in every month.

However, the tools required to calculate how much money you need to save for retirement include complex words like time value of money, inflation, and rate of return and so on.

One of the most helpful **nudges** in helping people save money is the **default opt-in option** in pension plans. By making' default enrolment' in pension plans, savings moves from a reflective system decision to an automatic system decision. Furthermore, reducing the number of 'plan options' within the mandatory pension schemes makes it even simpler for people to choose the most effective plan.

Nudges that help in investment choices

In investment decisions, poor choices lead to wrong investments at the wrong time. The tendency to follow others leads to investing in over-valued stocks and joining a rally at the wrong time. Another choice where investors err is the debt-equity ratio of their investment portfolio. When to invest and where to invest are complex choice systems and the need for the right **nudge** becomes critical. Offering investment plans that are labelled aggressive, moderate and conservative regarding returns and risk, is a good **contextual nudge.**

Using the **RECAP** (Record, Evaluate, and Compare Alternative Prices) framework is a good nudge to help people reverse their errors made at the time of investment. By giving complete transparency of how the investment is performing, and periodically sharing options to the current choice, is what RECAP is all about.

Similarly, using the incentive heuristic of **Who** *uses? /Who chooses? /Who pays? /Who profits?* helps ensure that the incentive nudge is designed to help the investor and not the seller alone.

Nudges that help in managing loans

Regarding borrowing, mortgages, and credit card loans being the most common, choices are becoming complex with fixed and variable rates of lending, interest-only loans, teaser rate mortgages and many more. The borrowing (or lending) industry has the most predatory practices, which fleece or penalise customers for making the wrong choice.

The industry says that people should read all documents and clauses before signing up, which as we know, is a reflective system decision, something that humans do not want to make. Generating transparent interest reports is a much-needed nudge in this industry.

One way credit card companies use a nudge in a negative manner is enabling only the minimum amount due as an auto-payment option. Extending full credit amount auto-payment will be a positive nudge for those who can clear off their credit amount in one go.

Doctors as choice architects

Choices play an important role in health. Along with choices comes the inherent biases that make us choose the least resistance route. In the case of health related choices and decisions, **doctors play the role of choice architects.**

For example, the chances of self-examination in breast cancer detection increases when the risks of non-examination are highlighted rather than the lower risk on regular examination.

In the case of government-sponsored or funded programs, a critical error in the choice architecture of these programs is the overload of choices that are offered to those who sign up.

Offering too many choices for complex decisions related to health coverage, that too in the future, makes it a complex structured choice, leading to poor choices, and therefore lower subsequent sign-ups. A large-scale US government Medicare program had the default option of non-enrolment!

Similarly, most state-funded Medicare programs do not offer the RECAP nudge to enable people to correct their earlier wrong choices. These are major design flaws regarding choice architecture, and influence the poor response of some of these programs.

Nudge for organ donation

Another health-related challenge is the massive gap between demand and supply of organs for transplantation. It is believed that in the US, there are 12000-15000 potential organ donors. Each eligible (brain dead) donor can donate three organs, which means that the number of lives that can be saved by organ donation is three times the number of donors.

However, less than half of the eligible potential donors, become actual donors. One key reason for this gap is the need for **explicit consent** of the surviving family members of the potential donor.

In a study in the US, it was found that 97% of the respondents were 'willing to be organ donors' if such a situation arose. However, the organ donation process requires the explicit consent of the surviving family members, unless the 'organ donation consent box was 'ticked' in their driving license.

Can make default opt-in for organ donation in the driving license check-box help in increasing number of actual organ donors? A milder variant of this 'choice' can be the mandated choice where the driving license holder has to necessarily decide yes or no for organ donation.

Nudges that will help the environment

The choices for health become more complex when it comes to the impact of environmental changes on our health. The reason for this is the extremely long time gap between the stimulus (now) versus impact (later, regarding global warming and so on).

Nudges should be created in such a way that people can visualise how their choices today will impact the environment for the generations to come.

Nudge you towards school

When it comes to schools, especially in the context of the American education system, do more choices help? Before answering this, it is important to understand that the current way of choosing schools is fairly simple-the parent decides the school for the child, and it is usually the default choice of the neighbourhood school.

By publishing information about the school's performance regarding test scores, quality of facilities and so on, schools can help parents make a more than default choice. Enabling parents to visit schools and meet teachers before their children join the school is also a good nudge to help the parents choose a better school.

In San Marcos, Texas, the school administration designed an effective nudge to get school students to join college. The school administration made it a mandatory requirement for graduating students from the San Marcos school to complete an application to a nearby college.

The nearby college, Austin Community College, required a high school degree and just a record of having taken a standardised test, of admission. By filling just the college form, the San Marcos school students were eligible to join college.

This nudge helped San Marcos school increase its student's college acceptance rate from 34 per cent to 45 per cent.

Where do you stop nudging?

In the case of cigarettes, the nudge that began with education on the harmful effects of tobacco is today a screaming warning on the cigarette pack with heavy taxation.

Just like with cigarettes, will we move from a nudge to an aggressive position against usage and consumption? The answer lies not in stopping nudges altogether but in doing something, and subsequently deciding whether the nudge needs to continue or should it move to become a screaming warning.

Similarly, there can always be a risk of **bad nudges,** especially as we saw in the case of predatory practices in the lending and borrowing industry. The rules of engagement and transparency should help us understand whether the nudge is a good nudge or a bad nudge.

An extreme view might be that in a free society, **people have the right to be wrong,** and that, at times, it is better to learn from mistakes. However, this approach can lead to wrongful inclusion, where the poor might end up choosing something that further pushes him into poverty, while the incentive structure benefits the seller.

It is possible to for choice architects to preserve freedom of choice and continue to nudge people in a direction that helps them live better.

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