Story Arun Abey & Andrew Ford

Money means different things to different people, so how to make the right choices? Arun Abey and Andrew Ford wrote a book on the subject.

How much is enough?

MOST PEOPLE SAY THEY are good money managers. Yet couples often break up because of financial stress, one in two executives spends more than they earn, and few investors fully capture the long-term return of the sharemarket. So how good are we really? What is it about money that causes otherwise sane people to lose their heads? And how much is enough?

What does money mean to you? It sounds like an obvious question, but ask 10 different people what money means to them and you'll get 10 different answers. To some people it means having all the "stuff" that money can buy. To others it means less stress, a sense of freedom or perhaps passing on a legacy to the people they love.

The good news is that as a society we're wealthier than ever, providing choices that were not available to our parents, let alone our grandparents. The bad news is that beyond a basic level of income, as society grows richer we're not becoming happier. An outward focus on materialism has brought with it a financial flu that has been labelled affluenza.

Americans now encounter 3000 advertisements every day telling them what to buy, and we're no different here. With so many options, how can we make good choices?

Dealing with choice overload

Psychologist Barry Schwartz has identified two ways we deal with choices embodied in two consumer types: maximisers and satisficers.

Maximisers spend hours, days, even weeks wading through possible choices. They scour the internet for the best mobile phone deal, drive miles to save a few bucks, and curse themselves when a better offer appears later. It takes them forever to make a decision, so they waste time.

Satisficers stop searching once they find something that serves their need, enjoying a more regret-free life with more time to spare. While maximisers may end up with a better product, they are less satisfied in the long run. Chances are you'll be happier as a satisficer.

Living consistently with our personal values is one key to taking a practical rather than slavish approach to money. Instead of asking, "How much money do I need to be happy?" first ask "How can I be happy?", and then determine the contribution that money can make.

Martin Seligman, Professor of Psychology at the University of Pennsylvania and one of the founders of the Positive Psychology movement, has developed a comprehensive understanding of what happiness really is. There are several routes to authentic happiness, he says, each one different.

Seligman distinguishes between pleasures, such as good red wine, that tend to be momentary, and gratifications, such as painting or dancing, that evoke a sense of flow and last longer. By organising your life for plenty of both, you can enjoy the good life. To live an authentic life it's important to look inwards and develop your own answers to the question: how much is enough?

Mind power is a key to success. While the brain has evolved to help us deal with these questions, nothing could have prepared us for the complexity of the stockmarket. We are ill-equipped and exposed to emotions and biases that have the potential to destroy wealth faster than the meanest bear market.

One insight that can make a big difference to long-term financial success is that on average, shares have out-performed cash and fixed-interest investment by around 5% -7% annually.

Barring extreme events, while the level of return varies dramatically from year to year, this basic relationship should continue to hold true. The return above the cash rate from shares is called the equity risk premium, but we call it The Prize.

Say you invest $100,000 today and received a 4% return for 30 years, compounded monthly. Ignoring inflation and taxes and assuming you reinvest all income, after 30 years you have $331,350.

If you invest the same amount of money over the same period but this time your average return is 5% higher (the lower end of the historical range of the equity risk premium in the US), at the end of 30 years you come away with $1,473,057. Suddenly retirement is a much brighter proposition.

A good financial adviser can give you a portfolio that is diversified across the asset classes from shares to property, bonds and cash, and at least tracks the long-term performance of these markets. However, the difference between success and failure is not how investment markets behave but how you, as an investor, behave.

By investing in a quality diversified portfolio of shares, available from any number of competent fund managers, it's not that hard to capture The Prize. Yet many investors still fail.

Mental traps in volatile markets. Our brains evolved in an environment – the African savannah – where all that mattered was survival. So we're hard-wired to think about today, not tomorrow. Those who can overcome this instinct when it comes to investing generally win.

When markets experience major swings as they have in the past nine months, money moves from weak hands to strong hands. Here

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10 steps to money & happiness

Start out with a financial plan, goals & values

1. Money alone probably won't make you happy. Living an "authentic life" will. Despite more wealth, people are not necessarily happier.
2. Establish a financial plan. Those that have one report greater life satisfaction.
3. Base your financial plan on your goals and values, not those someone else says you should have.
4. Have a financial adviser who plans for you, not just for your money.
5. Capture "The Prize" (see main story). It helps you get the most from your savings and fund your retirement.
6. Understand the "enemy within". You are wired to make bad decisions both in terms of investment and what will make you happy. Learn to overcome this.
7. Beware false accounting. An investment you bought for $100 five years ago and sold for $150 yesterday, but which cost you $4 in transaction costs, $10 in finance interest costs, and $11 to maintain and insure, made a 25% return, not 50%.
8. Do not attempt to chase fads, or time the market. Most likely you will fail. Invest at regular intervals. This helps to even out the unpredictable ups and downs.
9. Do not watch your investments constantly. Review annually, in the context of your long-term objectives.
10. Be generous of spirit: giving with a sense of appreciation is an enduring source of happiness.

How Much is Enough? by Arun Abey and Andrew Ford is published by A&B Publishers and is available from good bookstores. Check out www.howmuchisenough.net.

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are some of the problems that lead to wealth destruction in times like these:

We are loss averse Research conducted in the 1970s by psychologists Daniel Kahneman and Amos Tversky found that the pain of a loss is more than double the pleasure of a gain the same size. In other words, losing $1000 has more than double the emotional impact of winning $1000. We like to win, we hate to lose.

This explains why investors will go out of their way to avoid a loss, and expose themselves to even greater losses, for example by selling at the bottom of the market. Risk-averse investors may avoid loss, but in doing so they also lose the possibility of significant gain.

We suffer from saliency. That is, we focus on sensational headlines, and when these are bad we tend to make it worse by our tendency to "catastrophise", rather than coolly analyse the whole picture.

Herd behaviour is compelling. In stockmarkets success goes to those who are willing to stand alone. But stockmarkets are new creations requiring new behaviours to be successful. For much of human evolution, standing alone while the tribe moved in another direction guaranteed death. Do not underestimate how emotionally difficult it is to be patient in stockmarkets when your peers are moving to the sidelines.

Emotionally we are not geared for long-term planning. We discount time hyperbolically. Put simply, this means we value instant gratification highly and place little value on saving for the distant future.

We choose poor mental anchors. The tendency to latch on to an initial piece of data against which we then judge all future information is a trap known as anchoring. When we invest, we risk becoming "anchored" to the current prices of assets and vulnerable to misjudgments about the future. In a rising sharemarket, we assume that current stock prices are roughly fair value, and each new market high becomes an anchor against which subsequent highs are judged.

Anchoring works in other ways too. For example, if a company performing poorly announces startlingly good news, which is likely to lead to a large increase in earnings, most investors still under-react. Our price "anchor" is so low that, instead of re-assessing the company's outlook, we are more inclined to consider the news in relation to our previous (negative) view of it and inch up our expectations only slightly.

This is why equity research analysts usually raise their company earnings' forecasts in small shifts. In these circumstances, competent fund managers and investors may be ahead of the market in identifying news that is genuinely good.

We are overconfident in our abilities. Anchoring is worsened by the propensity for us to be excessively confident of our abilities as investors, particularly if we have enjoyed recent success. This contributes to our tendency to DIY without the skills and experience, make decisions too rapidly without sufficient analysis, fail to diversify portfolios sufficiently or trade investments too frequently.

Research shows that if we have done particularly well from investing in shares, we move our activities online, trade stocks more frequently, speculate more and (as a result) achieve lower returns. In theory trading through the internet should lower costs and lead to faster processing, but in fact it leads us to trade too often, as we can act quickly and easily in our over-confidence.

The key to guarding against these mental mistakes is to understand the traps and be properly prepared, so that you can keep perspective during the inevitable fluctuations in the stockmarket.

Here are some tips from Warren Buffett, the world's most successful investor

- Consider volatility as a friend which provides opportunities.
- Undertake rigorous analysis on companies within your circle of competence, before making decisions. This provides confidence and mental fortitude to see the fluctuations in markets as good rather than bad.
- Have reasonable expectations of performance, be patient and avoid the distractions of greed and peer pressure.

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The Bridge of Wellbeing

If you define success in terms of personal wellbeing rather than money alone, it is helpful to have a framework to understand the role of money in your life, and make the right choices. We call this framework our Bridge of Wellbeing and the three pillars that underpin it are:

- understanding and defining your values and goals;
- deploying financial strategies that use your resources in a way that is consistent with your values and goals;
- developing your investment strategy.

1. Understanding your values and goals

Many of us spend too little time thinking about what would make us happy, and disproportionate time and effort chasing goals that don't bring the satisfaction we seek. When setting goals, it's important to look forward, not back. Suspend reality and the limitations of the past and think about the things to which you genuinely aspire.

One aspect of determining how much money is enough is planning for security in retirement. The general rule of thumb is that once work stops, the kids leave home and expenses fall, most people find they need something like 75% of their final working income for their remaining years to sustain a good lifestyle in retirement. You can probably get by on less but it's worth aiming high.

2. Applying your resources to achieve your goals

US behavioural finance experts Richard Thaler and Shlomo Benartzi of the University of Chicago and UCLA respectively have identified the following constraints to having enough money in later life:

- many people want to save but lack self-control;
- investors are very sensitive to perceived losses;
- people procrastinate about making changes to their savings plan.

You can begin to work out how much money is enough by mapping out your financial resources today and in future:

- identify your current income and expenditure by doing a budget;
- estimate income and expenditure in the medium (3 years) and longer term (5-10);
- balance your current and future needs and goals.

3. Developing your investment strategy

A sound investment approach comes down to the Four Principles: Quality, Value, Diversity and Time. Investing in a diverse range of quality investments at prices that represent good value, and investing for sufficient time, will bring you the rewards you seek.

Quality: The only way to identify quality companies is through rigorous analysis. Look for attributes that include sound longer-term earnings, good return on equity, capable management with a solid track record, a sound balance sheet, and reliable core business franchises.

Value: Some of the worst disasters have arisen from people paying too much for what are, essentially, quality assets. The key to assessing value and quality is to know whether an asset can produce an attractive return relative to its risk.

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Diversity: This means having access to a wide range of investment opportunities, rather than just a few. Diversification usually involves having investments across different asset classes, countries and funds.

Time: The ultimate test comes with Time. Over long periods in the market, say 5-10 years or more, virtually all strategies based on the above four principles have greater upside potential, with less downside risk, than chasing hot stocks and hot sectors. Ultimately, crossing the bridge of wellbeing means integrating all aspects of your money and your life to help you answer that most important question: how much is enough?

Giving with meaning

Finally it's worth considering not just what you can do for yourself but what you can do for others. There is no doubt that others will benefit if each of us becomes more generous of spirit, but research suggests that giving helps the giver too.

Simply writing a cheque to a charity that you may not know much about doesn't seem to do it. It's giving something with meaning and purpose that seems to really make a difference.

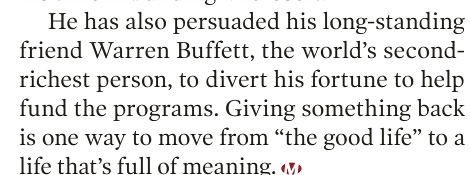
Take the example of a young Bill Gates. Initially he was influenced by others to enter Harvard Law School. He soon found that it was not for him and, fortunately, had the courage to pursue what for him was an authentic path, even if it involved disappointing others.

Gates dropped out to focus on what for him was a gratification, developing the software to bring personal computers to life. Anyone observing Gates as he built Microsoft into one of the world's most successful companies would have no doubt that he was fully engaged and derived tremendous satisfaction from this. But it wasn't enough.

Some years ago, he was shocked to discover how little was being done to treat diseases in poor countries, especially malaria. As he did more reading and research, including visiting some of these countries, he developed a huge passion to solve the problem. He also developed an interest in tackling the educational disadvantages of the underprivileged.

Gates has now decided to donate most of his fortune, his time, his skill and his formidable creative energy to these causes. Those who know him observe that he has never been more engaged or passionate, not even during his time in building Microsoft.

He has also persuaded his long-standing friend Warren Buffett, the world's second-richest person, to divert his fortune to help fund the programs. Giving something back is one way to move from "the good life" to a life that's full of meaning. M



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