Know thyself: Investing and speculation

Brandon Snow, May 31, 2018

"Never let the facts get in the way of a good story."

-Attributed to Alan Radlo (originally Mark Twain)

As the cycle goes, so does the interest and emotions of investors. Coming out of a bear market, people are worried about downside risks. Mistrust is rampant, people feel deceived (likely because they were coaxed, by themselves or others, to take on too much risk near the top), and they feel stupid for having "lost money" in the downturn and for not listening to the *permabear* who was right for one year of seven…and sounded so smart because of that. The focus is on value, safety and protection, and people DE-RISK.

And this 'works' for a while; and *feels* good. Many will have de-risked their asset allocation, preferring the safe feeling government bonds provide. As the returns flow in and investors claw back what they have lost, they become more comfortable with risk. Even more importantly, they *feel* more confident in their ability to judge and take on risk. They are 'smart' again, and that *feels* good.

At some point this willingness to take on incremental risk turns into a focus on returns *before* risk, and investors begin to speculate. People start hearing stories, second-hand at first and then first-hand, about someone who made some unbelievable amount of money on _____________ (doesn't matter what it is, the outcome is important, not the substance) and they want in on the big returns too.

They want in because of a few well established human biases:

First, the majority of people think they are more intelligent than average. In addition, the more educated someone is the more likely they are to believe they are smarter than average. Risk-on speculative markets can make anyone rich: so the fact that your less educated cousin/brother-in-law/acquaintance/whomever (the proverbial shoe-shine boy) made such a return means you should be able to do even better!

Second, boring is hard. One of the unique things about humans is our ability to imagine many future possibilities: we get caught up in what *could* be. This is a great virtue to keep us focused and determined in normal course, but also opens us up to undue risk-taking because: a) the slow and steady approach to wealth creation is boring and hard, and b) people have a very difficult time judging low-probability events. Unlike the assumed rational individual, people are willing to take on high-volatility, low-probability of success risks when they think the outcome could change their situation dramatically. We will delude ourselves into believing the moon shot is a sure thing because of how much we desire the projected outcome, and how hard it would be (and how long it would take) to get there the slow and steady way.

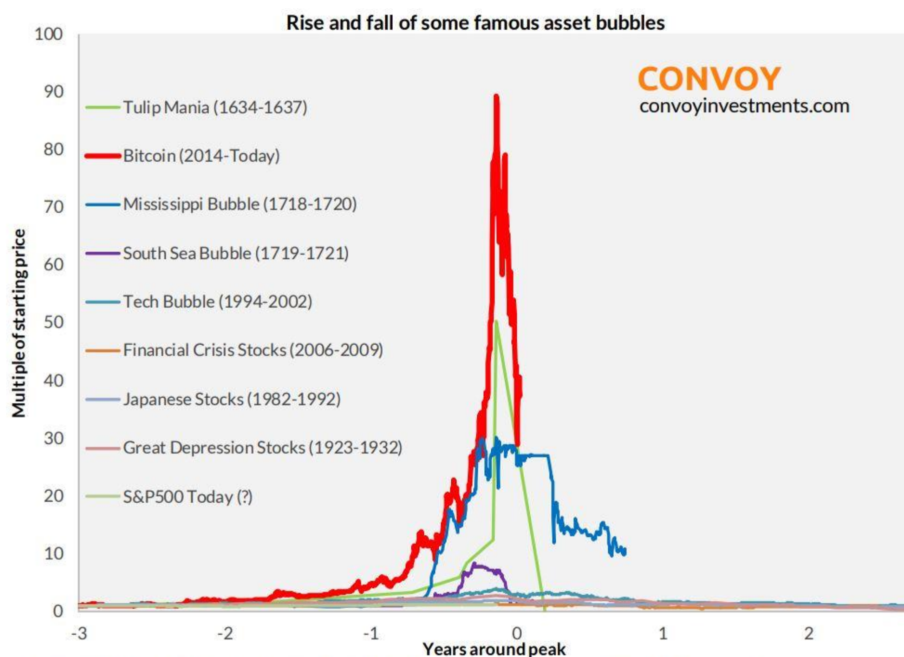
That’s human nature for you.

Of course, we operate in an industry that is rife with greed and duplicity. There are agents in the financial industry who enable and encourage speculative risk-taking by others for their own benefit. There are the investment bankers who are trying to ride the wave for their own profit: they are not owners of what they are selling. The ‘management’ of shell companies who change their name to see the stock pop so they can sell their shares. There are plenty of players who want to offer “advice” to take on these risks: they want you to attend their conference/subscribe to their newsletter/click on their tweet/buy their book/become their client (an associated crime of omission is those who will let you take on speculative risks so as not to lose you as a reader, watcher or client). And of course the major news networks and sources are all part of the narrative.

BEWARE ANYONE WHOSE INCENTIVES ARE NOT ALIGNED WITH YOURS.

A recent example of this is cryptocurrencies. I am not here to judge their value, because that is clearly subjective, but we recently went through a mania in crypto led by Bitcoin. Networks were so head-over-heels in covering this mania around the clock that they began to have ‘expert’ guests, with names like ‘Bitcoin Jesus’ on their programs.

When the currency was going parabolic, there were a lot of new issues, or Initial Coin Offerings (ICOs). Several companies changed their name to get involved in the craze: ticker CRCW, which sold exercise equipment, changed its name to “The Crypto Co.”, sending its shares from $11 to $600 in a month. After many speculators piled in it nosedived. As per Bloomberg, it last traded on May 9 at $42.50. In addition, bullish 'experts' were paraded across every screen and even CNBC had a Bitcoin price ticker on the screen all day long.



One of the best examples of the mania was the UE ICO, which stated:

"The world's first 100% honest Ethereum ICO. You're going to give some random person on the internet money, and they're going to take it and go buy stuff with it. Probably electronics, to be honest. Maybe even a big-screen television. Seriously, don't buy these tokens."

The UE ICO has since raised over $200k

What has happened since? Here are the stats:

Of course, when people lose money, they don't want to talk about it. They don't want to hear about it and they don't want to be reminded they got duped (again). So even though Bitcoin has fallen more than 50% from its highs and nearly 60% of ICOs failed, or are in the process of failing, why aren't we hearing about it?

Incentives and accountability go hand-in-hand. I don't know any of the agents (media, bankers, newsletter writers or experts) who are being held accountable today for their role in this mania.

So what is the point?

Our human nature makes us susceptible to speculation, something we have to a) accept, and b) develop strategies to overcome these instincts. There are agents who profit from speculation often by risking other people's hard-earned money, and we need to avoid these influences.

In order to achieve the best long-term investing outcomes I encourage you to do three things:

1. **Remember incentives are key. Demand accountability:**
   Ensure the people from whom you seek advice have the same purpose as you do – which is most likely the long-term compounding of your wealth. If they get paid by trading or by generating ratings and page views, they are working for their own self-interest at the expense of your wealth. **Look for owners, like you**.

2. **Understand you will want to speculate and be prepared**:
   Set a budget for speculative investments within your portfolio if you would like to experience the thrill, but only if you can adhere to a strict discipline. For example: My great-aunt used to like 'playing the ponies'. Even though she lived on a fixed budget, she set aside a small amount of money to go to the racetrack every week. This was her entertainment and she had the discipline to keep it in check**. If you don't have the discipline, your budget should be ZERO.**

3. **Focus on the benefits of compounding:** Reminding yourself of its value in the long-run and, accept that it isn't intuitive: our primitive brains can be short-sighted and fail to understand how small benefits can build up over time to huge gains. Run some simple math to remind yourself that even 7% per year compounded for 10 years will allow you to double your money.

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