ADVISOR PERSPECTIVES

Twenty Rules for Life: Morgan Housel's Antidote to Financial Chaos

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Morgan Housel
Source

In a fascinating little book, *The Psychology of Money*, the investment manager Morgan Housel provides more useful self-help advice than most authors who explicitly set out to do so.

My title and subtitle are a takeoff on Jordan Peterson's wildly successful book, *12 Rules for Life: An Antidote to Chaos*, a mostly abstract work of philosophy that nevertheless counsels such actions as cleaning your room. Housel's book, likewise, is an antidote to chaos and is shorter, simpler, and more accessible than Peterson's. Each of the 20 chapters of *The Psychology of Money* sets forth a rule for life that goes well beyond finance and that readers would generally – but not always – do well to follow.

I confess to a little disappointment when I first skimmed the book. It is brief, easy, and completely non-technical. I wanted to be challenged intellectually. But, when I read the book carefully, I found myself more challenged and rewarded *psychologically* – is Housel's take on human nature accurate? Are the common mistakes he documents that universal? Can we explain them through biology, psychology, and personal history, as Housel does? These are bigger questions than how much to save so you can retire at 65, how much to put in emerging markets, or how big the equity risk premium is. Housel addresses those questions fearlessly.

But sometimes wrongly.

All "rules for life" are too general, and it is fun to note the exceptions. Where I do so, I use the label "pushback" to alert the reader that I'm disagreeing with Housel or finding one of his rules incomplete.

Let's look at some of Housel's most striking rules.

"No one's crazy"

In Housel's first chapter, he asserts that our financial behavior, no matter how strange or self-defeating, isn't "crazy," but a product of our unique experiences. These can be personal, generational, ethnic, or anything else. For example, John F. Kennedy – that rarest of birds, a politician who spoke about himself truthfully – said, "I had no first-hand knowledge of the Depression. My family had one of the great fortunes of the world…I really did not learn about the Depression until I read about it at Harvard."

This was despite Kennedy having been 12 years old in 1929, when the Great Depression began, and 23 in 1940 when it was over. Is it possible to be that insulated from one's nearby surroundings?

My father, two years older than Kennedy, was thrown out of his house by both parents (separately) and was a street urchin at 13. Is it any wonder his only investments were cash and bank deposits, and that Kennedy was a daredevil? Neither was crazy; each was following his inner directive, shaped by personal experience.

But here's some pushback: People who follow the inner voice shaped only by their own experience don't seem very smart. A parade of gifted entertainers from Isaac Hayes to Johnny Depp have wasted their entire fortunes, close to a billion dollars in Depp's case. Is he crazy? I would say, "yes"; his inner voice is failing him on one of the most important issues in life, how to handle money.

Bill Gates was more than just lucky

In a chapter emphasizing the role of luck as compared to skill, ambition, and other traits of successful people, Housel notes that Bill Gates was startlingly lucky to be exposed to computers at a young age because, of the "roughly 303 million high school-age people in the world," Gates was one of the 300 who attended Lakeside School. Lakeside is a top-notch prep school in Seattle, and – almost uniquely among the schools of the world, in Housel's estimation – had a timesharing computer terminal.

Housel is right that we habitually underestimate the role of luck in life. An example close to the heart of investors is the topic of winning active managers. If all active managers did was to make random bets, about half of them would have above-average track records, obviously due to luck and nothing else. Active managers don't really do this – many have real skill – but it's hard to tell skill from luck just by looking at the numbers, and we're inclined to attribute most or all of the alpha from a favorite manager to skill. And, when they falter, as they inevitably do, we tend to write off the run of poor performance as just bad luck – without any hard evidence that either conclusion is justified.

Pushback: Lakeside was not "one of the only" high schools that had a computer; it was one of a small but not infinitesimal number. Mine, Hawken in Ohio, had one too, and I used it. I attended high school two years *before* Gates. Why am I not Bill Gates? Setting aside differences in intelligence, I'm not as motivated; I didn't care *that* much about computers; and I don't have the genes of an entrepreneur. Two of my classmates became fairly famous computer scientists, but so did a lot of people of our generation.

Warren Buffett made 96.5% of his fortune after his 65th birthday

Yes, this little Housel tidbit is true. But it's not entirely fair. The first billion is always the hardest. In addition, Buffett is 90 years old. The compound annual rate of return between Buffett's 65th and 90th birthdays is an impressive but not miraculous 14.3%. He probably earned a higher return than that, because he spent some and gave a lot more away. But he had to have earned quite a bit more than 14.3% per year *before* he was 65 to accumulate $3 billion by that date. Most people never accumulate $3 million, much less $3 billion.

The lesson Housel draws from this story is that very long stretches of time in the market are the sources of some great fortunes. Get rich slowly. That's good advice: Start early and never stop. But, no matter how hard you try, you're not Warren Buffett (unless you *are* Warren Buffett and you're reading this).

Getting versus staying wealthy

"You should only have to get rich once," intoned Lyn Hutton, the respected chief investment officer of Commonfund Capital in a client meeting long ago. A later author, Russell Holcombe, used this aphorism as the title of his book. The saying could not be more right.

The tragic tale of Jesse Livermore is Housel's way of emphasizing this theme.[1] Livermore was one of the world's great speculators, traders, and short sellers ("the Great Bear of Wall Street") in the years leading up to the Great Depression. During the 1929 crash, he was short the market and increased his fortune while others were losing theirs – an event that may have been his downfall. He probably thought that he had special knowledge of how to time the market.

When the market crashed again in 1930, 1931, and 1932, Livermore turned bullish. He made large, leveraged purchases and lost everything. Deeply in debt, Livermore took his own life in 1940, about when the market would have made him rich again if he had been able to hold on. That is something that unleveraged investors can do if, unlike Livermore, they do not let their spending run wild.

Keep some money for yourself.

The art collector…or index fund manager?

Typical of Housel's little morality tales is the story of Hans Berggruen, the German art collector who, decades after he fled the Nazis in 1936, "sold part of his massive collection of Picassos, Braques, Klees, and Matisses to the German government for more than 100 million euros."[2] His secret, says Housel, was not skill at selecting great art investments, nor was it luck. The investment firm Horizon Research, quoted by Housel, argues that it was patience and diversification:

> The great [art] investors bought vast quantities of art. A subset of the collections turned out to be great investments, and they were held for sufficiently long periods of time to allow the portfolio return to converge upon the return of the best elements in the portfolio. That's all that happens.

Housel then explains,

> The great dealers operated like index funds. They bought [everything they could]. Then they sat and waited for a few winners to emerge… Berggruen could be wrong most of the time and still wind up stupendously right.

This is indeed how equity index funds work: as Hendrik Bessembinder, a professor at Arizona State, showed, only 4% of all stocks outperformed low-returning Treasury bills over the period from 1926 to 2019.[3] But some of those that did were huge winners. Thus, the good performance of equity indexes over long periods of time is mostly caused by a select few issues. Which ones, you can't know in advance.

Hans Berggruen and one of his priceless Picassos

Source

Pushback: While any given index fund works this way, a *portfolio* of index funds, diversified across asset classes, only does so if you never rebalance. Otherwise, the gains on the way to huge success are harvested early and reinvested in the less successful asset classes. This is the right thing for most investors to do. The purpose of rebalancing is to control risk. While the return on a never-rebalanced portfolio is indeed dominated by the return of its best investments, that portfolio could fall 22% in one day or 57% in a year and a half, as the S&P 500 did on October 19, 1987 and in 2007-2009 respectively. More recently, in early 2020, that same index fell 34% in 23 trading days. Ouch!

Another way of looking at this is that Berggruen did not care about risk. That is easier to do (or pretend to do) when you own assets, such as paintings, that are not marked to market. There is no way to measure or fully experience the risk of a sudden decline in the value of paintings, unless you are in the process of selling them. But investors in public securities markets *should* care about risk, and should not follow the Berggruen strategy, other than to the limited extent of buying and holding index funds (or other funds) and allowing them to appreciate up to the point where the size of the holding pierces investor's risk threshold.

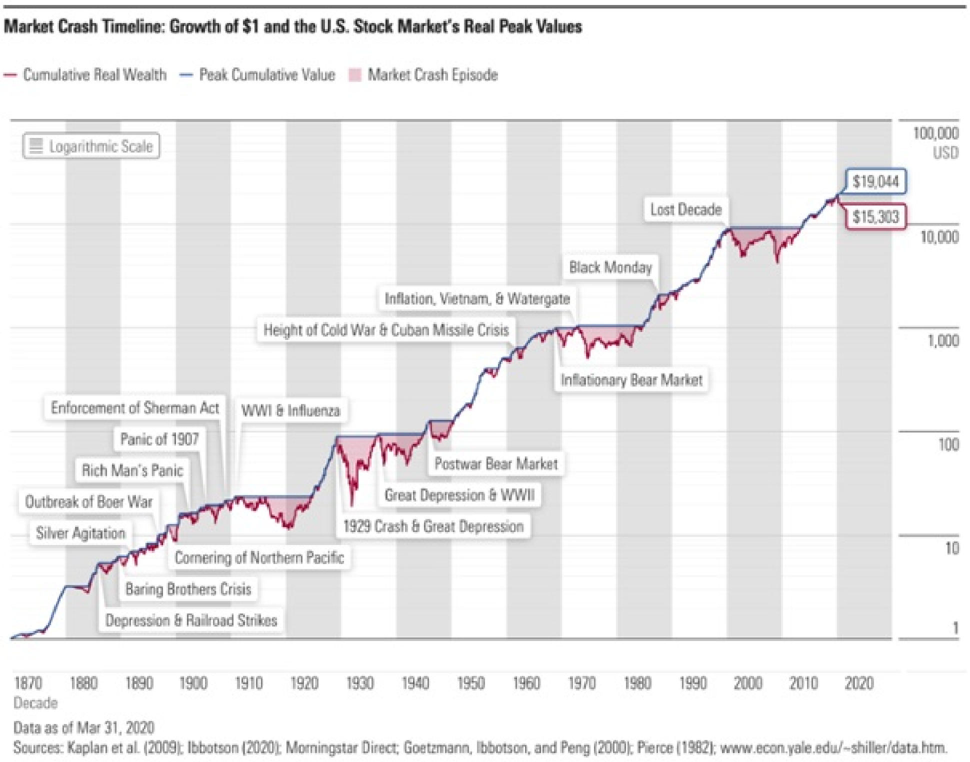
Wealth is what you don't see

This is a quickie. My wife recently walked by a big fancy house and remarked, "So-and-so must be really rich. They just paid $2 million for that house." I replied, "Yeah, they used to have $2 million and now they don't."[4]

Housel makes this point vividly: Wealth is the part of your cumulative income that is *not consumed*. You can't see it. It is in the bank, or the stock market, or some other market. What you *can* see – consumption – is the part of the person's wealth that they used to have and don't anymore. If someone appears to be rich, you have no idea whether they are or not. Just ask Jesse Livermore.

History doesn't repeat itself

…but it rhymes, Mark Twain is supposed to have said. Look at the well-known Ibbotson chart, extended back to 1871 by Morningstar to get as long a time period as possible. It's hard to tell one half-century from another. The market booms, it crashes, it stabilizes, it booms, it crashes again. On the log scale used in the chart, the real (inflation-adjusted) level of the U.S. stock market total-return index fluctuates around a *straight line* representing compound annual growth of 6.8%. The straight line implies a stable or predictable rate of return. So, can't we foretell the future of investment returns by extrapolating the past? That worked well enough most of the time.



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No, says Housel, echoing cautions expressed by Roger Ibbotson and many others since long-term historical market data first became available. Ibbotson and his colleagues would lower their forecasts of the future because interest rates are lower today than ever before, and *possibly* because stock prices are high relative to historical norms. But Housel has a different set of concerns, related to changes in market structure and institutions:

- Private equity as a means of financing business activity has become huge. We have less data on its historical performance than we do for public equities.
- The composition of the market keeps changing. Looking back over history, railroads, industrials, oils, and financials have each had their turn as the biggest components of indexes. Now it's technology. According to Housel, this has never happened before, but I would *push back* by saying that many companies that we now call industrials were the technological leaders of their time: Edison Electric (founded in 1880, about the time the extended Ibbotson chart starts), Westinghouse, AT&T, General Motors, IBM, Boeing, and many others.
- The mass popularity of individual investing for retirement only began with the invention of the 401(k) account, a little over 40 years ago. Meanwhile, traditional pension plans have all but disappeared outside the public sector.

Despite these profound changes, I agree more with John Templeton's aphorism, "the four most dangerous words in investing are 'It's different this time'," than with Housel's comic riff on it, quoting Ritholtz Wealth Management's Michael Batnick: "The 12 most dangerous words in investing are 'the four most dangerous words in investing are "It's different this time"'."

Meaningful changes are taking place all the time, but study the past carefully.[5]

The child is father to the man?

The child is father to the man, wrote Wordsworth,[6] but don't count on that working out exactly. Everyone changes, some more than most. Housel relies on this principle to argue that one's life plan must be flexible enough to allow for substantial change in oneself and one's goals and desires.

To drive home this point, Housel recounts the story of a young man, "the hardest-working guy I knew," who for many years wanted nothing other than to become a doctor. Despite only moderate ability, and 10 years older than his classmates, he powered through and got the coveted M.D. diploma.

How did that turn out for him? "Awful career, man." The stress and long hours had worn him out. He is not alone. Doctors are getting MBAs so they can work for or run biotech firms; some are simply selling their practices and are willing to do anything but doctoring. (I don't mean to discourage any would-be doctors among my readers.) One reason is that the industry has changed – in fact, it used to be called a profession and now it's better described as a regulated industry – but another reason, just as valid, is that the person you were at 18, pursuing a pre-med degree, no longer exists at 40 or 50.

Investors should be prepared for career changes and other surprises. *Mann tracht, und Gott lacht,* goes a Yiddish proverb (channeling a Biblical verse).[7] Man plans, and God laughs.

Optimism and pessimism: Mithridates, he died old

Are you an optimist or pessimist? I am a cautious optimist, and I have written a book reflecting that posture, *Fewer, Richer, Greener*. The title summarizes my vision of the future of humanity. I also acknowledge problems and suggest ways of fixing them.

Housel says that he, too, is an optimist by temperament. Yet, in a CFA Institute *Enterprising Investor* interview, he advocated balance, just as he does in the book:[8] "You need this barbell personality of optimism about the long run of the market's ability to solve problems and create productivity and produce profits that accrue to shareholders."

"But that's just one side of the equation," the interviewer, Lauren Foster, remarked. Housel continued, "You also need pessimism about the short run about being able to survive long enough to benefit from the long run. I've often said, 'Save like a pessimist and invest like an optimist.' You need both and they seem contradictory: Long-term optimism and short-term pessimism, if not paranoia."

Yet Housel calls himself a "permanent optimist." Let's explore this idea a bit.

It's an odd optimist who is attracted to the bittersweet poetry of A. E. Housman. In his famous poem beloved by cynical schoolboys, "Terence, This Is Stupid Stuff," Housman argues that people who prepare for the worst are the happiest because all surprises are then pleasant surprises. I am that odd optimist, a fan of Housman's since late childhood. Housman's poem includes the tale of Mithridates, an ancient king who expected to be poisoned (a common fate for kings in those days) and steeled himself with small doses of various poisons so he would be immune. The poem concludes, "I tell the tale that I heard told/ Mithridates, he died old." The strategy works.

Housel seems to hold a similar view. Like me, Morgan Housel, while professing optimism, sees both sides: "Expecting things to be bad is the best way to be surprised when they're not. Which, ironically, is something to be optimistic about." This balance is what allows him to see the rich opportunities that await investors who commit capital to long periods of time in the market.

I told you this was no ordinary investment book. Or self-help book. It is new and different.

Conclusion

I close with two of Housel's reading recommendations from an interview with Chris Reining, a popular minimalist blogger and "supersaver":

> Reining: You're a voracious reader. What book had the biggest influence on the way you think about money and life?
>
> Housel: I'll give you two. *The Quest of the Simple Life* by William Dawson. It completely changed how I think about financial goals. *The Better Angels of Our Nature* by Steven Pinker. It made me a permanent optimist.[9]

I am not all that much into simplicity – I prefer a life rich in both experiences and material goods – but Housel is. Whatever your financial and personal goals, you will almost certainly get closer to them if you follow Morgan Housel's simple principles.

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[1] The real Jesse Lauriston Livermore (1877-1940), not the pseudonymous modern commentator who runs the excellent http://www.philosophicaleconomics.com blog, which I highly recommend.

[2] The Berggruen Museum in Berlin is named after him, its chief benefactor. Berggruen lived from 1914 to 2007.

[3] Bessembinder, Hendrik. "Do stocks outperform Treasury bills?" *Journal of Financial Economics*, volume 129, number 3 (September), pp. 440-457.

[4] In addition, we can't tell by looking at the house whether it was bought with spare cash or with a mortgage at the outer edge of the buyer's ability to pay.

[5] To his credit, Housel softens his cautions about relying on history by saying, "The further back in history you look, the more general your takeaways should be. General things like people's relationship to greed and fear, how they behave under stress, and how they respond to incentives tend to be stable over time."

[6] "My Heart Leaps Up" (1802).

[7] Sometimes said to be Proverbs 19:21. Rendered in modern German because transliteration of Yiddish is not an exact science.

[8] October 22, 2020, https://blogs.cfainstitute.org/investor/2020/10/22/morgan-housel-on-greed-and-fear-frugality-and-paranoia/

[9] Source: https://chrisreining.com/morgan-housel/