CHAPTER I

Avoid These Mistakes and You're Halfway There

Susan: One of the toughest decisions I ever had to make in my chess career was not which piece to move on the board. Instead, after I had moved to the United States, I was confronted with a test of allegiance. Having spent my whole life representing my homeland of Hungary at the chessboard, I was asked to go to the 2004 Chess Olympiad and lead the American team to its first-ever medals in the sport.

Though my relationship with the Hungarian Chess Federation, once considered a puppet of Soviet controllers, was often tenuous, I had finally achieved recognition from them. In my early years of serious competitive chess (1982 – 1985), the Communist party tried to hold me back by not letting me play in, nor travel to, important international events. However, after the 1988 Chess Olympiad, the whole atmosphere changed. My team, consisting of my two sisters, Judit (age 12) and Sophia (age 14), along with Ildiko Madl (age 19), and I (also 19), defeated the Soviets. Since they had dominated the game for decades, our victory over them turned us into overnight national treasures.

Switching federations to the United States Chess Federation could certainly be seen as unpatriotic. However, I knew that I was not abandoning my roots. Rather, I was fulfilling my desire to popularize chess in the United States and open the door to American women to show them that they, too, could follow their dreams.

What I didn't expect, though, shortly after my announcement, was to hear someone call me by my Hungarian name. "Zsuzsa!" a Hungarian chess fan summoned me. I looked towards him and he continued, "If you play for the Americans against Hungary," he paused and stepped very close to me, "I will kill you." For a moment I thought he was kidding. I looked at him and smiled tentatively. He just stared at me for a moment and then walked away. He didn't smile back. I had thought my decision about switching federations was complicated, but the added element of an attack on me, or perhaps my family, who was still in Hungary, frightened me. I had a hard time assessing the situation. For me, decisiveness was a trait I had worked on building my whole life. But how could I make this choice? What if I made a mistake?

Chess games will always end up being a draw unless one side makes a mistake. Maneuver your pieces skillfully enough until your rival messes up, and you can count on winning. But how do you keep yourself from making a blunder? In investing, too, bad mistakes – as opposed to rough markets – regularly cause investors to damage their long-term chances of financial security.

Chess experts improve their odds of success by studying chess "tactics," the specific moves to make in different situations. The better their recollection of the countless possible board positions *and* the time-tested responses, the more likely they are to conquer their opponent. In fact, winning has little to do with brilliance; plenty of smart people play chess poorly. Triumph on the board comes from having practiced the tactical skills necessary to deal with the obstacles that opponents create.

Likewise, smart investors sometimes fail because they haven't learned the skills that will help them to manage their own money. Many of the tactics that grandmasters use to dominate a tournament also pertain to handling personal finance, and anyone can apply them. By understanding the sixty-four chess tactics in Chapter IX (one for each square on the chessboard), you will make better investment decisions. Why not start by learning those tactics? Since people lose both games and money as a result of making mistakes, we first need to identify the common barriers that stop people from making the right moves. So, stay tuned for the *Rich As A King* tactics later on but for now, learn from other people's mistakes.

Hate to lose? Here's why.

In the fields of finance or chess, regardless of how well you prepare your strategy and plan your moves, if the odds don't roll in your favor, you lose. Interestingly, in both worlds, the amount that people find intolerable to lose doesn't correspond with the amount they hope to win. The fear of losing, known as "loss aversion," trumps the joy of winning in most situations, and this imbalance frequently causes people to make poor choices. Going for the least-chance-of-defeat decision may at first glance seem wise, but this strategy certainly won't make you a winner.

Professor Daniel Kahneman won the Nobel Prize (Economics, 2002) for his ground-breaking work in behavioral finance by describing the phenomenon of loss aversion. Giving the illustration of flipping a coin, he discussed the question of how much test subjects would want to win if losing meant that they'd have to pay $20. "For most people," he said, "when you have a bet with a 50% chance of losing $20, you want to have an equal chance of gaining $40." Kahneman uncovered an astonishing psychological barrier that stops people from advancing. Since the average coin flippers stipulated that in order to agree to play the game, their potential winnings had to equal twice their possible losses, imagine how this stunted their potential to ever get ahead. In theory, a flipper should rejoice if he wins, for example, $21 when he only has to put $20 at risk. Illogically, though, he won't place the bet unless he has the chance to secure a $40 pot.

The disproportionate way in which people regard winning versus losing helps to explain why investors often make decisions based on one of two emotions. According to traditional wisdom, either fear or greed causes people to make an investment move. The flipping study shows that fear motivates people about twice as much as greed does.

What happens when investors' dread significantly outweighs their avarice? They tend to panic when the market drops and they sell. Maybe they started in stocks as long-term investors who thought they could stomach volatility. But when some bad news flashed across their screens, such as the S&L bailouts, Black

Monday, the Gulf Wars, the presidential impeachment, the Russian bond default, the dotcom crises, the terror attacks on the Twin Towers and the Pentagon, the real estate collapse, the banking meltdown, the Japanese nuclear reactor explosions, the European debt crisis, and more, they sold. They suffered from loss aversion, bailing out when economic darkness prevailed.

After the markets recovered, these same investors bought back in, emboldened by their greed. What really happened, though, is that they sold when the market was low, and bought when it went up – a formula for failure on Wall Street. In one twenty-year study[1] that looked at the impact of people chasing market returns, the stock market (as measured by the S&P 500 index) averaged about 8.2% per year, but shareholders in equity (stocks are often referred to as "equities") mutual funds only made about 4.3% on average each year. Investors trying to time the market, selling after it dropped and buying after it already started to recover, caused their own problems. Had they just stayed with their funds when the markets took a hit, they would have almost doubled their returns. As Kahneman summed it up, "The main implication for loss aversion in investing is that you have to think about what you could sustain without changing your mind or without changing course."

In chess, too, the fear of a potential loss outweighs the thrill of winning to such a degree that tournament participants often offer or accept a draw even if they have a superior position – just to be on the safe side. In order to limit loss aversion and encourage the fighting spirit, many high-level chess tournaments now incorporate a system that assigns zero points to a loss, one point to a draw, and three points to a win. In the traditional model, a win earns one point, a draw gets half a point, and a loss gets zero. By making a victory much more valuable than two ties, players opt against acceding to a draw and will instead fight full-guns for a triumph. This rule came about as a result of tournament organizers witnessing how loss aversion caused players to avoid risk and accept the half-point result. For chess viewers and players, the tendency to avoid jeopardy makes the matches rather dull. For investors, the rigid avoidance of risk can cause other problems, not the least of which is that people may not earn high enough returns on their investments because they keep them too safe.

Regardless of how you characterize yourself as an investor (i.e., conservative, moderate, or aggressive), understanding the psychological barriers that cause

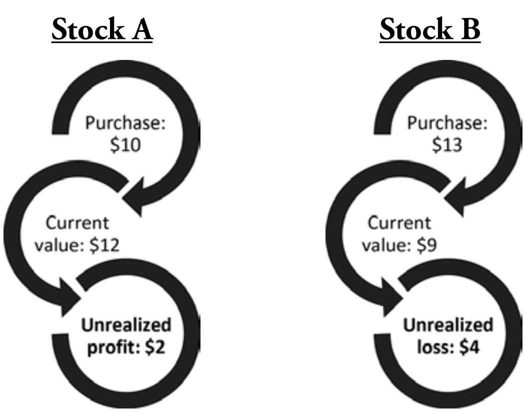
1 DALBAR, Inc., Quantitative Analysis of Investor Behavior, 2013, http://www.qaib.com/, September, 2013

people to make poor decisions should help you formulate your plans logically. Alternatively, if you can't stop yourself from succumbing to the emotional roller coaster of investing, consider one or both of these practical options:

- Assign some or all of the day-to-day management to a professional or
- Stay away from risky ventures altogether.

How to decide whether to sell *this* or *that*

Consider another common foul-up known as the "disposition effect," which causes people to err when choosing which stock to sell. Professors Hersh Shefrin and Meir Statman first introduced the concept in 1985 to describe investors' "disposition to sell winners too early and ride losers too long." Imagine you find yourself in a situation where you own holdings in two different companies, Stock A and Stock B, and you need to sell one of them to raise money to pay for your child's college tuition. You bought Stock A for $10 per share. Now at $12, the stock shows an unrealized $2 per share profit on your statement. On the other hand, since you bought Stock B for $13 per share and now it's trading at $9, you have an unrealized loss of $4 per share.



Presuming you must sell one of these two, which one would you select? Should you keep the profitable position or the unsuccessful one? Would you sell Stock A, thus realizing a gain, or would you sell Stock B, locking in the loss? In the end, most investors make the wrong decision and opt to sell the winner, Stock A. This application of the disposition effect leads investors to sell their profitable stocks while holding onto their losers. In fact, though, dumping the losers (since you get the tax benefit of selling at a loss) and keeping the winners (since they are often winners for a good reason – they're better companies) generally makes more sense.

Don't make an unbendable rule for yourself that you will only make decisions to sell based on which stock has outperformed the other, since the winner may not always beat the loser. Rather, stop yourself from making emotional trading choices ("Hooray! I made a profit on Stock A!") without considering the individual merits of each stock.

Professor Terrance Odean (University of California) examined the trading patterns of tens of thousands of investors, looking at millions of trades in different markets. He demonstrated how investors like the feeling of selling at a profit, even when selling a losing position makes more sense in terms of proper portfolio management. If they sell the profitable stock, they can tell their friends, "I made a killing on Stock A!" It certainly makes good cocktail party conversation. Moreover, they can rationalize that as long as they haven't sold Stock B, it can still come around and turn profitable. "Since I haven't sold it, I haven't actually lost any real money," they reason.

Though the joy of selling at a profit might have emotional significance, it can undercut the long-term growth potential of a portfolio. In fact, when studying similar decisions across tens of thousands of self-directed brokerage accounts, Odean found that on average, one year after people sold a winner, it had outperformed the loser (the stock they kept) by about 3.5%. If they had made the statistically rational (albeit emotionally more difficult) decision to hold onto the winner so that it could keep gaining, they generally would have pocketed more money.

When to sell an investment… or sacrifice a chess piece

Chess players, too, make poor moves based on the disposition effect. They may trade off pieces, feeling like they're gaining traction; however, later on in the game, they might find that those trades were merely cosmetic time wasters that set them back strategically.

Consider this real life instance of the disposition effect in chess:

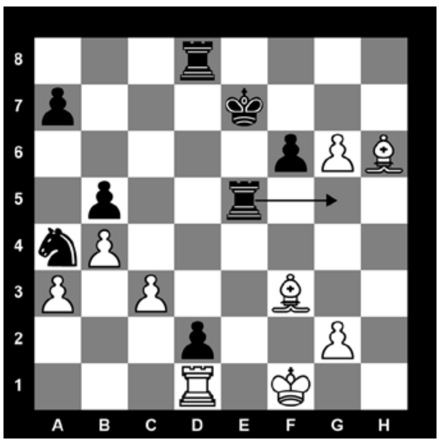
Susan: In my 1996 world championship match against China's Xie Jun, I was playing black in game #8. Towards the end *of the game, I had amassed a slight "material advantage," meaning that I had more valuable pieces than my opponent. Specifically, I had an extra rook (a.k.a. "castle"), which is considered to be better than the extra bishop + pawn that she had. In the left diagram below, you can see that I have my two black rooks, while White only has one. Also note that Black has one knight, but White has two bishops (knights and bishops are regarded as about on par with each other, though bishops are sometimes considered a bit stronger). A normal move in this case would have been for my black knight to capture the pawn on square c3 and then for White's rook to capture the pawn on d2, like this:*

Polgar: Black knight captures white pawn (Nxc3)

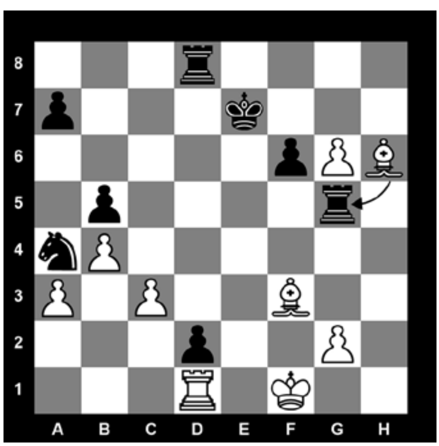
Jun: White rook captures black pawn (Rxd2)

Had I gone for this easy capture of the pawn, the game might have continued on for dozens of more moves, and its outcome would not have been certain. With only a slight material advantage, it could have taken me a long time to chip away at Jun's position. Had I suffered from the disposition effect, I might have disposed of the wrong piece, doing the pawn trade above. So instead of doing that swap, which would have had only a limited advantage, I did the equivalent of selling a losing stock. In the previous investment example, Stock B had gone down in value and, though it might have had the potential to go up, it appeared to be the weaker stock. Likewise, in my game with Jun, I determined that my own rook (on e5), which an amateur would say was quite precious (5 points), was not as valuable an asset as the pawn that was on the verge of becoming a queen, so I sold it. That is, I slid that rook to the right two squares (to g5), allowing Jun's *bishop to capture it. I let my rook go, since at that point it was more of a loser than a winner. In return, my pawn (f6) caught the white bishop. When I made that trade, I heard gasps in the audience. Onlookers were shocked, wondering why I swapped my 5-point rook for a less valuable 3-point bishop. But even though the rook might have succeeded over the long term, it made more sense to dispose of it, losing the material advantage in order to focus on the potential of the advanced "passed pawn"[2] on d2. In fact, Jun realized this a few moves later when she conceded the game. Take a look at how the final steps in my strategy unfolded:*

Black sacrifices rook (Rg5)

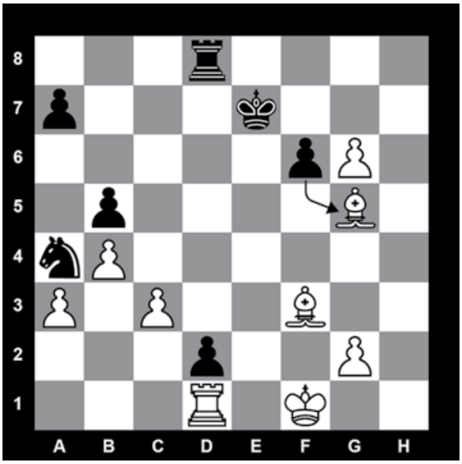


White bishop captures black rook (Bxg5)



2 A "passed pawn" is a pawn with no opposing pawns preventing it from getting to the eighth rank (where it can change into any other piece it wants, except a king).

Black pawn captures white bishop (f6xg5)



Observers whispered their disapproval of the decision to dispose of the underperforming rook. However, just because a piece comes with a great name, this doesn't mean you need to keep it. Consider the fate of some famous, highly valued companies like Lehman Brothers, Bear Stearns, and Merrill Lynch, all of whom used to top the A-list of Wall Street firms. Their ultimate time came, too, and just as you wouldn't want to hold stock in the d1 rook on the chessboard above (because Black would next move its knight to c3), you wouldn't want to have owned shares in those eminent companies. Buying a stock or holding onto a chess piece just because it has a legendary name may lead you to lose the game.

When you have to make a decision to sell, avoid letting the disposition effect blind you. Don't jump to sell shares whose prices have increased while keeping those that have dropped in value. Grandmasters don't do that, and investors shouldn't either.

***Rich As A King* Action Point:**

Pull out your brokerage statements and look at each position individually. Ask yourself, "If I currently had the same amount of cash in the bank as this investment is worth, would I buy this stock/bond/mutual fund now?" Ignore the past results of the specific investment, since the price at which you bought it and the price today are rather arbitrary figures. If you answer yourself definitively, "No, I'd never buy that security today," then sell it now, even if that means disposing of it at a loss. Don't worry about what you would buy with the proceeds. You don't need an alternative investment to buy as a criterion for selling a loser. If an enemy had your king in his crosshairs, you wouldn't start figuring out what other pieces could start an attack on your opponent; you would have only one choice – get your king out of danger. Likewise for this RAAK Action Point, consider the money in each of your investments as if it were a king. Is it well-placed or do you need to move it?

Where to look if you want to improve your portfolio

Imagine if someone summarized your whole financial picture on one page. Wouldn't that be great? Not only would it present all of your holdings, but it would also show you a bit of their history and their relative strengths. On top of that, it would catalog every possible vulnerability for you in an easy-to-read fashion. With all that information at your fingertips, would you make the right investment decisions? Unfortunately, the answer may well be "no." Even with all the information spread out before them, investors tend to only look at, and give relevance to, a small portion of the available information. This is also true of chess players. In a chess game, participants may suffer from what behavioral finance professors call "mental accounting." The players, in this case, focus too much on one part of the board to the exclusion of concentrating on the whole game. While carefully examining all the possibilities for, say, an elegant attack, they might completely ignore the rival bishop perched in the corner of the board. Then, as they complete their maneuver, their opponent swoops in with the up-until-now silent bishop and slays their queen.

Players get a sinking feeling when they accidentally give away a critical piece, similar to how investors feel when they realize that they missed something important because they have spent too much time focusing on just one part of their portfolio. For example, some investors might get so involved with trading their online stock account that they completely neglect the big picture, letting the rest of their money drift in the abyss of low-interest checking accounts and random 401(k) pension plan choices. Frequently, those with multi-million dollar accounts will agonize for days over whether to sell a hundred shares of a small stock rather than review the performance of their money managers who handle the other 99% of their liquid assets. Mental accounting, the tendency to look at one part at a time rather than focusing on the greater whole, leads people to poorly allocate their cerebral resources. In these cases, a wealthy investor might have purchased a small position years ago, and rather than selling the shares, or transferring them over to his professionally traded account, he continues to devote undue time and energy to reading the news, looking at the stock's fundamentals, and tracking the company's trading patterns.

To stop yourself from becoming overly focused on one aspect of your money picture, view yourself, or you and your spouse, as the Chief Executive Officers of your own company, "My Family, Inc." You have different divisions, each of which has certain responsibilities. The checkbook division handles the invoices that your company receives; the bond unit supplies regular income to cover your monthly expenses; and the stock department seeks out new opportunities to help grow the bottom line. Having your divisions set up neatly in front of you allows you, like a chess player who can view all the pieces at once, to analyze your whole board. Anyone who has ever sat in a chess class at Webster University in St. Louis has probably heard the quote, "Look at the whole board!" –SP. Remember those words as you examine the finances of My Family, Inc.

***Rich As A King* Action Point:**

Calculate your total net worth, including all of your assets everywhere (from stocks to bonds, bank accounts to IRAs, 401(k) plans to real estate). Put all of this data into a spreadsheet so you can see your asset allocation. Using this eagle-eye view of your investments, determine whether you have allocated too much or too little to any one asset class. This exercise helps you look at your whole investment board at once without getting sidetracked by the specifics. (Check out the free asset allocation tool at www.RichAsAKing.com/tools.)

You're losing money because of something you don't see

Can you stop yourself from mental accounting, the tendency to look at just one part at a time rather than seeing the greater whole? Can you keep yourself from getting distracted by the small details that seize your attention? If your thought pendulum swings too far in one direction and you only consider yourself a "big picture" thinker, you could easily miss the important facts that are on your statements. As documented in the popular book, *The Invisible Gorilla*, by Christopher Chabris and Daniel Simons, people often suffer from the "illusion of attention," believing that they see an entire scene but actually missing what's right in front of their eyes. The authors, both cognitive psychologists, present cases of how even experts overlook incredibly important hazards. For example, they note how an experienced airline pilot did not see a plane on the runway where he was about to land. And they ask how a veteran nuclear submarine captain could not see a 200-foot fishing boat that was right in the middle of his periscope view screen. Could a radiologist looking at an x-ray just miss seeing a guidewire in a patient's chest? Chabris and Simons explain that people believe that they can pay attention to the world around them, but in fact, they frequently miss obvious impediments because they just don't expect them. If this happens to experts, then surely armchair portfolio managers and amateur chess players alike will also miss critical information, even if *The Wall Street Journal* or some internet site screams the news in a headline. (Take a look at some of Chabris and Simons' fascinating videos at www.RichAsAKing.com/gorilla.)

If someone supplied you with that ideal one-page summary of your entire financial world, could you absorb the whole thing, or would mental accounting and the illusion of attention make you focus too much on one area or simply miss some critical fact? Watch out. The bishop in the corner that you forgot about or just didn't see can be vicious!

***Rich As A King* Action Point:**

Get an extra set of eyes to review your statements. Sit with your spouse, trusted friend or family member, or professional advisor to go over your affairs. Having an objective viewer offer insights helps to ensure that you don't miss a crucial element on your money board.

How the news causes you to lose

When your friends start spewing too many details about their recent barroom conquests, you might raise your hand to stop them and say, "Too much information." It's a pity that people don't behave similarly toward the bombardment of economic news. Many investors hunt for endless minutiae by mining research reports, websites, and blogs. These days, any reasonably savvy computer user can set up a professional-looking website with an impressive sounding name like, "ValueInvestmentResearch.com," and dish out whatever crosses his mind. As such, the viewpoints you find might actually harm your results.

Not all the news is tainted. Certainly many media outlets provide worthy data to analyze. However, sometimes people relate to this information in the wrong way. Suffering from "media response," they feel the need to react, which is too bad, since the low correlation between current events and long-term performance, compounded by a deluge of information, causes stress and often leads to poor financial decisions. In fact, studies have shown that people who make investment choices based on news commentaries perform *worse* than those who make their selections in a news vacuum. Apparently, the urge to "do something" when receiving new facts can cause suboptimal results. People move their pieces even in circumstances when doing nothing would probably be the best tactic. For some reason, doing something feels better than sitting tight.

Chess players who spend most of their time memorizing chess openings may get similarly baffled when trying to apply what they learned.

Susan: Club players who talk about the opening moves of my sister (Grandmaster Judit Polgar) may sound impressive, knowing how she opened in recent games. But if they don't fully understand the rationale behind her moves and if they merely try to copy her, once they are "out of book,"[3] *they'll tie themselves up in a complex situation that would require grandmaster-level skill to untangle.*

When playing in an important chess competition, players often mistakenly shift their concentration from checkmating their opponent to winning the whole tournament. Such contemplation distracts them from devoting their attention to their next move on the board. Though they may daydream about walking away with the trophy, they need to examine the pieces right in front of them. They must look at each situation on the board as a new problem to solve. If they can't shake the feeling of, "I've got to win this game in order to qualify for my grandmaster title," then they are likely to impair their concentration.

Individual investors, too, must focus on the big picture… but only sometimes. When you run into a store, don't refer to your financial plan as you browse up and down the aisles. Your monthly budget should guide you in determining how much you can spend on the outing. Though you derived that budget from your long-term strategy, keep all of your thoughts of the future within reason. You'll drive yourself crazy if you obsess about tomorrow, and you'll have a hard time concentrating on today's current decisions.

3 A game is "out of book" once the players have reached the end of the standard variations that they may have studied in instructional books about chess openings.

When playing chess, don't fixate on winning the game; think instead about which particular move will improve your position the most. Likewise, when shopping, don't get fixated on how this one purchase will affect whether you can retire comfortably; just make sure that you are spending within your budget. And when you are selecting investments, don't get preoccupied with how each choice may affect your ability to pay for your child's tuition; rather, confirm that the type of investment fits into your asset allocation model, and then look closely at the specific security to make sure that it makes sense for you.

Sometimes you must work on your big picture decisions, and sometimes on your tactics. Don't let an outside influence, especially one as powerful as the media, direct your energies to the wrong place.

Rich As A King Action Point:

If you're a news junkie, commit to limiting the time you spend on financial news on the internet, TV, radio, newspapers, magazines, and blogs to no more than thirty minutes per day for the next week. At the end of that period, ask yourself if the limitation diminished your decision-making capacity. Chances are you'll see that without the normal tidal wave of information, you still made perfectly sound decisions.

Why you should walk away from free offers

If you could tune into the stream of consciousness that a chess player has during a game, it might sound like this: "Inconceivable! She just gave me her queen. Ha! Without a queen, she'll have no chance. I'm going to win and move up to the next tournament round. Here I go, gently moving my pawn onto her queen's square. Yes! I'm removing her queen and dropping it next to the board. I can feel that prize money in my hands. Should I smile? No, that would be too crass. But I'm going to look up at her now. I just have to see her expression. Wait. Why is she smiling? How can she look so smug when she just gave away her queen? Unless she didn't just give it to me.… Oh no! She's going to mate me now. Ugh! She sacrificed her queen in order to trap my king. I thought I was getting it for free, and really it just cost me the game."

When your opponent gives you one of her pieces, don't assume that altruism has gotten the better of her. A smattering of cynicism would help if you asked yourself, "Why is she giving me her queen? What will she get from me in return if I take it?" Similarly, when a business offers you something gratis, figure out the company's ultimate goal and try to find out if you're really coming out ahead. Though "buy one, get one free" may tempt the consumer just like a seemingly helpless queen beckons its attackers, remember that you never get something for nothing. If you see that you can gain a free queen in a chess game, examine what the new position will look like after you take the piece. Will the capture open a pathway for your opponent to strike you later? Likewise, if you accept that special offer for a free iPhone when you sign a cell phone contract, will you have to commit to other expensive services at the same time?

Turning down a free offer defies human nature. As behavioral psychologist Professor Dan Ariely wrote in his best-selling book, *Predictably Irrational*, "We often pay too much when we pay nothing." In his studies, he showed that the possibility of getting something for free overwhelms a person's rational thinking so that a company well-versed in utilizing freebies in its selling campaign can conquer a market. Ariely cited the case in which Amazon started offering free shipping on orders that were over a certain dollar amount. People tended to increase the size of their orders in order to qualify for the benefit. Customers rationalized that if they bought only one more book or a couple of DVDs, they would reach the threshold and get the shipping for that magic price: $0.00. Amazon's executives found this model worked well, except in France. Many years ago, on the French version of the online store's website, customers who bought a specified amount qualified for a huge discount on shipping, paying only one franc (about ten cents). Though it was *almost* free, the psychological difference between a franc and nothing was enough to slow down sales. In fact, when Amazon subsequently dropped the one-franc fee to zero, sales growth in France began to mirror the other countries that had already been utilizing the totally free shipping model.

Ariely further tested how individuals react to a free offer, showing that the almost hypnotic effect of paying nothing will cause people to make the most illogical decisions. He ran a study in a mall in Boston offering two choices: either receive a free $10 Amazon gift certificate or pay $7 for a $20 gift certificate. Irrationally, most people chose the free gift certificate. Whereas they could have profited by $13 (the value of the $20 gift certificate minus the $7 cost), they instead selected the $10 free one.

Given the human propensity to want to get something for nothing, is it any wonder that brokerage firms advertise, "200 free trades," "free investment seminars," or "no annual IRA account fee"? They know that by using that potent word "free!" they will attract new customers. When getting something for nothing, the clients tend *not* to ask, "Do I really need to trade 200 times?" Similarly, they go to the seminars and get sold some program that they surely don't need. And what about the fee on the IRA account? Well, since the owners and employees of the brokerage firms expect to get a paycheck every month, you know the company will find another way to earn the lost income. Making money defines the essence of these firms. If they cut the cost of trading commissions to zero, they'll add fees for advisory services, banking products, borrowing, inactivity, account closing, yearly maintenance, trade confirmations or statements, and more.

***Rich As A King* Action Point:**

Next time you're about to accept something for free, analyze the other side's selflessness. If you can't figure out their motivation, then don't accept the offer. If you do succeed in discerning their motivation for giving you a freebie, then you've calculated the actual cost of the "free" item. Are you willing to pay that amount?

What men suffer from worse than women

> *People are actually paid to look overconfident and are handsomely rewarded for overconfidence.*
>
> —**Daniel Kahneman**, 2002 Nobel Prize Laureate in Economics

"This ship is unsinkable," proclaimed the builders of the *Titanic*. Talk about overconfidence! When individuals believe themselves to be greater, stronger, smarter, or luckier than normal, they misperceive reality and make poor decisions. For example, the vast majority of the population believes that they are above average when it comes to their driving ability, getting along with others, and having a sense of humor. But how could that be? The "average" represents the middle ground, so it's self-evident that most folks can't be better than the average. Moreover, people use random events to confirm their uniqueness; if they buy a stock that then goes up, they'll think, "I knew it was ready to jump." And if the investment drops, they'll rationalize this by saying, "I might have gotten the timing a little off, but I'll just hold on and it will recover." As Dan Ariely explained, "We tell ourselves stories [about what is going on in the stock market] that try to explain what happens. And even though we're just telling a story about a random pattern, all of a sudden we start believing in it. And because we believe in it, we believe in our ability to explain the stock market. … We say, 'Look at me. I really understand what is going on.' But it's not really understanding. It's just that you can tell yourself a story after the fact."

Overconfident investors tend to trade more actively than others. After all, they feel they have good ideas and a solid grasp of how the market works. However, as Professor Terrance Odean explained, "In general, active trading hurts people. Brad Barber [University of California, Professor of Finance] and I did a study in the U.S. where we looked at 60,000 individual investors. We sorted them based on how actively they were trading, and the 20% who traded most actively on average underperformed the buy-and-hold investors by about 6% per year." Moreover, men's overconfidence dwarfs women's. Not surprisingly, men trade more and do worse than women. In fact, Odean said, "Single men traded 67% more actively than single women … [and the men] underperformed single women by 1.4% per year."

With the wealth of investment information sites on the web, people develop even greater overconfidence in their abilities, suffering from what behavioral psychologists call the "illusion of knowledge." When studied, groups of informed investors were found to have an increased sense of confidence to forecast the market, which didn't keep pace with the accuracy of their predictions.

Chess players, too, suffer from an illusion of knowledge, believing in their abilities more than the facts warrant. For instance, in *The Invisible Gorilla*, Chabris and Simons describe a study where they asked tournament-level chess players two questions: "(1) What is your most recent official chess rating?" and "(2) What do you think your rating should be to reflect your true current strength?" Given the rigorous methodology used to calculate chess ratings, the two answers should be the same, or at least very similar. However, 75% of the respondents claimed that their actual score underrated their true ability by about 100 points. That staggering difference would be like someone saying that even though he got straight C's all through college, his true grade point average, if the school had properly rated him, would have been closer to an A. The authors conclude that the overconfidence that chess players have in the face of objective evidence to the contrary comes from the "illusion of confidence."

This two-pronged illusion of confidence, which (a) makes people overestimate their abilities as compared to their peers, and (b) makes people respect those who exude confidence regardless of their actual ability, can lead to poor conclusions in chess, in investing, and in life. Stock traders, hyped up by a few profitable trades, often think they have extraordinary insight into the market and as a result make bigger bets on a position than they should.

Doug: Consider the prospective client who wandered into my office in the beginning of 2000. He spoke about the "new economy," which at the time reflected the concept that brick and mortar businesses would vanish and internet-based companies would replace them. He said he had picked high-tech stocks and his portfolio had been making over 100% per year annualized. Not only that, but the twenty-two-year-old said that he was willing to drop out of school and become a money manager in my firm. When I asked him how long he had been trading stocks, he revealed that he had only started about two months earlier. He had calculated his annualized return by multiplying his actual return by six. Rather than showing the supercilious young man the door for being so brash, I suggested that he reconsider his approach and try diversifying. "Of course I've spread out the risk," the rookie said. "I've got WorldCom, Global Crossing, and JDS Uniphase as my biggest positions. But to really branch out, I've got a big holding in the NASDAQ index." Blinded by his illusion of confidence, he had no interest in listening to the rules of asset allocation. Instead, he ended up learning the hard way when his stocks crashed a few months later.

Though you need a certain amount of confidence for a healthy self-image, you also need to understand your limits. Don't assume you can predict the future of the stock market, and don't hire an investment advisor just because he wows you with his self-assured appearance.

***Rich As A King* Action Point:**

Answer the following questions with a range of numbers, not just a single figure. Write your responses on a piece of paper. Enter the range (minimum and maximum) of numbers within which you are 90% certain the answer lies. For instance, if the question asks for a specific year, give a range of years between which the particular event occurred. If you have no idea of the answer to a question, then expand your range of possible answers in order to feel 90% confident that the true answer lies somewhere between your two guesses. On the other hand, if you think you can give a good educated guess, then choose a smaller range and still be 90% confident. Go ahead, grab a piece of paper, and take the test. Don't turn the page until you have written all the answers. If you don't write them down, this experiment won't work. (Try this test online and get a free PDF version that you can print at www.RichAsAKing.com/overconfidence.)

	Minimum	Maximum
1. John F. Kennedy's age at his death		
2. Year that the Statue of Liberty was dedicated in New York		
3. Number of countries in the world (as of 2013)		
4. Air distance, in miles, between Alaska and Spain		
5. Number of bones in the human body		
6. Average distance in miles from the earth to the moon		
7. Average amount of vegetables an American eats in a year (in pounds)		
8. Length of the Amazon River (in miles)		
9. Year that Beethoven was born		
10. Population of Iceland (in 2013)		

1. 46
2. 1886
3. 195
4. 5032
5. 206
6. 239,000
7. 415
8. 4000
9. 1770
10. 322,000

If you were 90% confident of your answers, you should have missed only one. Most people miss five or more. The fact is that we are too certain about our answers, even when we have limited knowledge about a topic.

If you have the investment savvy and experience of Warren Buffett, or when you reach the chess heights of Grandmaster Garry Kasparov, *maybe* you can justify thinking that you know best. When grandmasters analyze a game they played, they tend to vigorously defend each of their decisions, including the questionable ones. Even the greatest players suffer from overconfidence. In the famous man vs. machine fight, when Kasparov played against IBM's chess computer, Deep Blue, Kasparov seemed to believe that the computer was too materialistic and would not sacrifice a piece. Whereas the human had an intuitive sense for a good move, the cold-hearted computer had no emotions. Finally, even the world chess champion showed his weakness. As can happen to anyone, his overconfidence eventually blinded his understanding of the opponent… and he lost.

José Raúl Capablanca, a Cuban chess player who reigned as world champion from 1921 to 1927, and who was known as the "Human Chess Machine," was once challenged to a game. Capablanca offered "queen odds" to the stranger, which meant that Capablanca would play without a queen. The competitor was insulted, perhaps feeling a little patronized, and he said, "How could you say that? You don't know me. You might lose." Capablanca replied confidently, "Sir, if you could beat me, I would know you."

In our own lives, for those chess players who haven't quite earned the title of world champion, and for those investors who aren't the "Oracle of Omaha," as Buffett is known, a little humility may serve us well in managing our affairs.