Human-Centric Investing Podcast

Episode 32: Back From The Future, Part 2 Time Travel

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Featured Guest: Annie Duke, decision strategist and former poker pro

Intro: This is the Human-Centric Investing Podcast with John Diehl where we look at the world of investing for the eyes of our clients. Take it away, John.

John Diehl: Hello, financial advisors. This is John Diehl, Senior Vice President of Strategic Markets at Hartford Funds. Welcome to Episode 32 of the Human-Centric Investing Podcast.

Joining me again today is Annie Duke. If you remember from our last podcast, Annie is a decision strategist and former poker professional. She's a world series of poker bracelet winner, she won the 2004 tournament in champions and the only woman ever to win the NBC National Poker Heads-up Championship. But, importantly for all of us, she has authored four books on poker, but in 2018 released her first book for more general audiences called Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts.

And that indeed is what today's podcast is all about, it's about making smarter decisions when we don't have all the facts. And let's face it, most of the decisions we make in the investing world, we don't have all the facts. We can set people up for success, but we're not in total control. And so on our last podcast, Annie talked about the concept of resulting and if you remember, if you've listened to the podcast lately, we ended talking about what we could do by overcoming this effect of resulting.

And Annie mentioned a couple of things, she mentioned retrospective, thinking about the outcomes and kind of what led to those outcomes. But we had just started talking about prospective planning, thinking about what would happen if some of the things occurred along the way that might affect our decision making, and I know Annie in your book you mentioned the concept of time travel. And so maybe off of that discussion of prospective planning, tell us a little bit about what time traveling is and how it impacts the way we might think about long-term decision-making.

Annie Duke: Yes. So one of your best – one of your best defenses against resulting is to actually think about things – think about the way that things might turn out in advance, and in particular – so that's kind of like the overarching that you want to do and then in particular, if you think about how things might turn out in advance from the perspective of things already having happened, you're even better off.

So let me just start with generally why do you want to really kind – think about what are the possibilities for – you know, if I make a particular decision, what are the ways that it could turn out, how – take a stab at how likely those things are turn – going to turn out so that you can get some sense of what that future looks like. The reason why that's really important is this, when we're thinking about the future, we can see the possibilities more clearly.

You can kind of think about it, if you're standing at the base of a tree and you look up, you can see all the branches of the tree, and let's call each of branches of the tree a different way that the future could go and let's imagine that the thickness of those branches represents how likely that path is to occur, right? So thick branches are really likely to occur, little tiny twigs are unlikely to occur, but even the tiniest of twigs has some chance of occurring, right?

If I'm thinking about the future and I'm saying, "Oh, it could go this way" but it's only going to go this way 2 percent of the time, that's not zero, right? It means it's going to happen 2 percent of the time.

So here's the problem with resulting, here's basically what happens to us from a cognitive standpoint is that once one of those branches is the branch that actually unfolds, right? If we think back to what we talked about in the last podcast, once that ball is passed in the Super Bowl by the Seahawks, by Russell Wilson, and the ball is intercepted, so that's now the future that actually unfolds, that now takes up all of the cognitive landscape for us. In other words, it overshadows all the other things that could have occurred.

Imagine it's like you have – your mind has a chainsaw and once the ball's intercepted your mind's chainsaw just lops off all of the other possible branches and the only thing that's left, the only thing that's left is the interception branch, that's the only thing you can see. So, what happens is that you – when that's the only thing that you can see, now all of a sudden that appears to be inevitable because it's the only thing that there is.

So what we're trying to do is make it so that that branch doesn't feel like it's the only thing that could have happened, that that branch doesn't feel like it's inevitable and that's the only, obviously the decision had to have in some, sort of, deterministic way, like, led to that particular thing happening. So what we're really trying to do is first of all keep the tree intact, right? We're trying to keep all of those branches on the tree so that even when that interception occurs, we can still see that there were lots of other branches, OK?

So when we do this advance planning, when we say, "Here are all the ways that things could go. And here's the likelihood of those things going" and we actually do that in an intentional and explicit way, what happens is that then when one of those things happened now we still have the whole tree in our view, we're just much less likely to lop off all the other branches.

All right. So that's kind of the first thing, that's like the overarching thing. But the better we are at figuring out what that tree looks like, obviously, the better we're going to be when we have a particular outcome of looking back and seeing everything for what it was.

The best way to see what the whole – what the – all of the possibilities look like, it's actually to get yourself to the – basically to the end of your goal looking back as opposed to trying to stand – like, instead of standing at the base of the base of the tree and looking up, you want to be standing on top of the tree looking down.

So using another nature metaphor, we can think about it like a mountain. So let's say that I have some, sort of, goal – some, sort of, retirement goal for what my net worth – what I'd like my net worth to be at retirement or how I'd like my portfolio to have performed over 10 years, let's say that I'm benchmarking to, like, the S&P500 and I say that at the end of 10 years I would like my portfolio to have outperformed the S&P500 by however many basis points.

So we can think about whatever goal it might be, we can think about non-investing goals, like, let's say that I had a goal that I wanted to avoid processed sugar for the next six months, so that could be a goal that I set for myself. So I'm trying to think about how is it that I get there? Like, how does the future unfold, what could it possibly look like?

Well, I could say, "Let me think about all the – how can I avoid sugar over the next six months?" And I could ask myself that question and I'm sure that I'm going to come up with answers that are, like, "Well, I'm not going to – I'm going to eat really healthy and I'm going to have healthy food in my pantry and I'm going to cook dinner and I'm going to think about all of these things that might get me to that goal."

But if I imagine that it's actually six months from now and I am thinking about, how did that go? I'm actually going to see the path much better and we can do this in two ways – excuse me, I have to cough. OK. So actually, let me go back because that was – let me – let me just start that fresh because that was – that was a little roundabout.

OK. So let me think about this again. So when we're trying to achieve a goal, when we're trying to kind of like get to the end and have a particular outcome, when our natural tendency to do is is to imagine, like, "Oh, I'm going to make great decisions and then this is going to get me to my goals." So when we think about, like, a strategic plan or we're thinking about how am I going to get to a goal, we tend to think about all the things that we're going to do that are going to help us achieve that goal and that's just the natural way that we think.

But the problem with that is that we're not getting a full picture, and the way to get – because what we're not seeing is we're not seeing how might luck get in our way and how we would deal with that? We're not seeing in that situation what are all the stupid things that we're going to do that might get in the way. But if we imagine a goal having actually standing at the end point and looking back, now we can see much more clearly what the path to that goal is, we can see much more clearly what the obstacles in our way are.

We can see much more clearly how things might change over time. So let's take this example, so let's say that you're standing at the bottom of a mountain and you're looking up trying to figure out how to get to the top of the mountain. What's going to be most in your view is just the base of the mountain.

So you're going to be thinking about all the stuff that's directly in front of you, you're going to be kind of overweighting that, you're going to be unlikely to be imagining how things might change as you head up that mountain. You can't see the appropriate path anyway, all you can see is sort of the immediate decisions that you have to make.

And this is exactly what happens to us when we're doing this kind of forward planning. But imagine instead that you could somehow get yourself to the top of the mountain and look back. Now when you look back from the top of the mountain, you can see the whole path, you can see all the obstacles in your way, you can see that the terrain doesn't look the same at the base of the mountain as it does at the top because naturally things change. You're much more likely to anticipate the way that things might change. You're much more likely to anticipate the way that, for example, luck might get in your way.

So we could think about – like, let's take a simple example of a goal, like I want to avoid processed sugar for the next six months and then we can take an example of from investing. So let's imagine that I have a goal that I want to stay away from sugar for the next six months.

If I'm planning that from the base of the mountain, I'm just going to be thinking about, "Oh, you know, I'm going to clean my pantry out and I'm going to have really healthy food in there and I'm going to cook for myself so that I make sure that I know what's in my food and this is what I'm going to do and it's going to be great."

But if I actually stand at the top of the mountain and I ask myself. "What are the things that might have made me fail?" So this is what's called a pre-mortem, what are the things – imagine it's six months from now and I made a commitment that I was going to not eat any sugar for six months and I failed at my goal, what happened? This is the thing that actually gets us to understand what those possible futures are. This is the thing that actually gets us to see where the places are where things might go wrong.

Now all of a sudden I can see, "Well what went wrong?" "It was my birthday and I had cake and then it was my kid's birthday and I felt bad so I had cake again." And then, "I had a bad break up, so I had cake." "Something sad happened to me and I felt like I had to comfort myself." "We're – we were out at dinner with friends and all my friends ordered dessert and I didn't want to feel left out and so I ate the dessert."

"It felt unfair for my kids for me not to have cookies in the house, like, why should I punish them because I'm – because I don't want to eat sugar, and then I was eating cookies at midnight." "There were donuts in the break room," whatever it is.

But now all of a sudden, instead of focusing on all the great things you're going to do which is the way that we naturally think. Now because I've said it's six months from now and, "Why did I fail – like, I failed at the goal, I didn't make it, I ate sugar along the way. Why is it that that happened?" I can now see all of those things that might cost me to fail. Now, that's called a pre-mortem.

Now you can do something in tandem with that which is to imagine success. So it's six months from now which is what my goal was, it's – I'm looking back and I see that I actually succeeded in not eating sugar. So I can go through that exercise as well, it's an important exercise to do, I can see all the ways that I avoided sugar, I can see that got the sugar out of the house, I can see that I packed my lunch and brought that to work with me and so on and so forth.

The thing about a back cast is that it's important to do because you definitely want to see the path to success, but it's not nearly as important as the pre-mortem. And the reason is that when we're thinking about our goals, we tend to think about the ways that we succeed, not the ways that we fail.

And so it's much – it's actually better for success to imagine the ways that we failed much more so than imagine the ways that we've succeeded, because once you've imagine the ways that you failed, you can actually put – you can actually basically do pre-commitments, you could – you could think about now in advance what are the things that are going to stop me from doing the things that might cause me to fail.

John Diehl: So Annie, you've mentioned – you mentioned not only the sugar example but how would one apply this to investing or investing goals?

Annie Duke: Sure. So let's imagine that my goal is that in five years I would like my portfolio to have outperformed the S&P500 by let's say two basis points, I'll just make that up. So let's say that that's my goal though, and now I imagine that it's five years from now and I've actually underperformed the S&P500.

So I'll do this with you, so let's do this, we can do this as a – because it's really good if you do this with other people. So John, you have a goal and your goal is that at the end of five years you would like your portfolio to have outperformed the S&P by two basis points, it's the end of five years and you've underperformed the S&P, what do you think happened?

John Diehl: I probably over allocated to certain sectors when things were hot.

Annie Duke: That would definitely be one way that would happen, right? So does that mean that you were moving your money around?

John Diehl: Yes. Probably more so than I should have.

Annie Duke: Than you should have, right. So that right there reveals a problem, right? So it was likely that when stocks were doing really well, you reacted to that and you moved your money out of cash and bonds into stocks and when stocks were underperforming you probably panicked and you moved your money out of stocks into bonds and cash, does that seem pretty reasonable?

John Diehl: Yes. Because if I think about it, to beat the S&P500 where I really have to beat it are times when stocks are down, right? Because – so my guess is that when stocks were down, I wasn't allocated properly to the areas that could have protected me more.

Annie Duke: Right, exactly. So we can see – we can see that, right? And then we can also see for, example – like, I'll give you a different goal, let's say that we're not now benchmarking to the S&P and all we're saying is that you would like your – you would like to earn, say, 4 percent year-over-year on your portfolio, let's say that that's a goal, I mean that's obviously a pretty big goal, but let's say that that's a goal.

You want to earn 4 percent year-over-year on your portfolio and it's the end of 10 years, so you have a 10-year goal that this is what you'd like your portfolio to do and at the end of 10 years you've lost money, OK? So now we're not pegging it to the S&P, right? We're just saying that this is the goal that you have for your portfolio. So at the end of the 10 years you've actually lost money, why do you think that happened?

John Diehl: Maybe the economy was worse than I anticipated?

Annie Duke: Right. So now notice here that what happens is that that luck shows through. So now what you've done is you've identified a way in which luck might intervene negative – that has a negative impact on your portfolio, right?

So generally what we could say is that one of the ways that you get there that has nothing to – really actually nothing to do with your decision making, right, is that the economy tanked. So one of the ways that you get there is obviously through decisions where you're reactive to the market, the stocks are up and you move your money and stocks are down and you move your money and you're moving it around all the time and then all of a sudden at the end of five or ten years you've underperformed the S&P somehow, which seems impossible but it's because you're making all of these in the moment decisions reacting to the – to what sectors are doing well and what sectors aren't.

But maybe you underperformed just because the economy doesn't do well, which isn't – doesn't have to do with your decisions. So once you identified that luck might intervene in this particular way, now you can think in advance about, "OK, so let me think about that, because some percentage of the time the stock market is going to be down," that's going to happen some percentage at a time. So now what you can do is you can ask yourself, "What can I do in order to reduce the influence of that luck on how my money ends up doing?" And, of course, the answer…

John Diehl: I could be better allocated, right?

Annie Duke: Right. You can be better allocated, exactly. So what you can do is you can say, "If I look in advance, I can see that sometimes the market's going to be down and sometimes the market's going to be up."

What I want to do is try to figure out in advance how can I hedge against the possibility of a – of a bear market, of the – of a market really, of a big market downturn, so that I can think about that in advance. Now obviously a hedge cost you something, right? Like you have to buy the bonds but what it does is it protects you against unforeseen luck.

So, like, here's an example – here's an example that I think is very relatable that actually came from (Michael Madison) gave me this example which I think is a wonderful example. If you – if you want to – we can do a pre-mortem. I want to have my wedding outside so I imagine it's after my wedding, it's a day after my wedding and the wedding was a disaster, it was miserable. Why did that happen?

Well, one of the things – one of the obvious ways that my wedding becomes miserable, if I'm having an outdoor wedding is that it rains. So I could see, "OK, maybe it's going to rain." So now I can walk through and I can say to myself, "Well, is there some way that I could reduce the influence of rain which I have no control over, that I could reduce the influence of rain on the quality of my decision?" On the – sorry, "Is there some way that I could reduce the influence of rain on the quality of the outcome, right, on how good my wedding ends up being?"

And the answer is, "Of course, I can. I have two choices. I could choose an indoor venue instead, right? Maybe I could do that but maybe that makes me sad, because I actually would like to have an outdoor wedding."

So how do I have an outdoor wedding and still not ruin my wedding, I can hedge it because I could have a tent. So I can have a tent off to the side which is, like, my back up plan, obviously the tent cost some money and I may not actually use the tent. I may not need the tent but the tent is really important because if it rains, then the tent comes into play.

So we could think about this, like, obviously if you knew that the stock market was going to go up forever, you would never have any money in bonds or cash, but the problem is that once we do a pre-mortem and we say, "What could make it so that we really lose money in our portfolio, that has kind of nothing to do with us, it just has to do with luck." Well, we don't – we don't actually have control over the economy. So if the economy tanks, that's what's going to happen.

At which point we just really need a tent, and doing the pre-mortem allows you to see the need for the tent and when you do that, what happens is that it reduces the chance that you're going to react to the stock market going up and now all of a sudden move your money, because you understand so much better the reason that why you have the tent off to the side.

John Diehl: So Annie, in all of your examples and we're – and we're drawing near to the end of this particular podcast, but every time you describe one of these scenarios whether it's the wedding scenario, the financial scenario, or even the nutrition scenario, I mean in my mind I immediately see the role of an advisor, right?

An advisor maybe not to tell us exactly what's going to happen, I mean the wedding planner can't tell us that it's going to rain on a date a year from now, but what they can tell us is they've been here before, they've seen these kind of scenarios, here's some possibilities of what might happen and here's some options that might be there to deal with it, and it's almost walking us through that, in a similar way what I see changing in the financial industry is that we come from this age where the financial advisor was somehow supposed to have a crystal ball where they could tell us everything that was going to happen.

Well, we all know that's not true, but maybe the role of the advisor, I think about all these conversations that clients have with their advisors about reviewing their portfolio and saying, "Why did I underperform the S&P, right? Why do we own these bonds? Why do we own these international investments?" Well if we had this kind of conversation as a part of the investing process, perhaps there wouldn't be the need for that kind of explanation, is that right? Is that the proper role of an advisor as you see it?

Annie Duke: So I think – I think it's twofold, the answer is yes and I think it's kind – I think it's twofold. One is that the advisor when you're thinking about doing a pre-mortem and you're saying, "What's your goal?" OK, let's imagine it's five years from now or ten years from now, I assume when you're advising somebody that they have a long-term financial goal, let's imagine that you failed to reach that goal, what is it that caused that to happen?

The advisor is going to be able to fill in those blanks with the client a lot better. Mainly because the advisor's going to understand much more what the obstacles in the way are because they've been there before. So they just have to understand the terrain much better, right?

So I think that that's number one, is that there are going to be boulders that are standing in that client's way that the client may not see that the advisor sees very clearly. There are going to be ways in which the client may not imagine making a bad decision that the advisor can really explain that this is very – it's a very common error.

None of us want to think that we're going to panic and sell at the low, right? But the advisor can really show the client, like how often that happens, that this is a very, very common reaction and allow the client to see in advance that this is something that may happen and that we actually need to put something in place to really reduce the chances that you do that.

So they're just going to help to see the terrain better, number one. And then number two they're also going to really understand what the options are for dealing with what those elements of luck are that can get in the way of your goals and what – for dealing with what the decisions are that you might make that can get in the way of your goals, and then to help be a partner and helping you stick to the plan that you come to.

So imagine this, like, imagine that I'm having a wedding and I'm having an outdoor wedding and the wedding planner just purchases a tent off to the side and doesn't tell me why. Afterwards, when it's a beautiful sunny day, I'm just going to be mad, right?

I'll just be, like, "Wait, hold on, why did you pay for this tent?" Because nobody – you know, nobody's explained to me, "Well, you know, there's – this – if you think about it at the time that you're getting married, there's this probability of rain, this is obviously very high stakes because if your wedding gets rained on that's a complete disaster, this was…"

John Diehl: I just spent money that I didn't need to spend, right?

Annie Duke: Right. So if you haven't gone through this process and the wedding planner hasn't walked you through this process, I'm going to have a really bad reaction that I have this tent off to the side.

But if we've actually gone through the process and I have the wedding planner explaining to me this is how often people's weddings get ruined, I want you to imagine what it's going to feel like when it rains on you, how much is it worth to you to protect yourself against that, right? Now, whether it's sunny or not, I'm not sad that that tent was over the side. And that's where I think the advisor has such a great role is that – is that they can see the landscape so much better than the client can.

In a lot of ways, strangers can see your decisions much better than you can. Strangers can see you're biased much better than you can. Think about this in a simple way, like, how many times are you watching television news and you see some commentator and they say something and you just are saying, "Oh my gosh, that's the most" – like, you're clearly biased, right? Like, that's clearly confirmation bias.

So the thing is that the person who's speaking probably doesn't know that they're engaging in that, but you can see that so easily when you're looking at somebody else so much more so when you're looking at it yourself. So when you're asking clients, "Hey, what do you think the bad decisions are that you're going to make along the way," that they're much less likely to see those in themselves and an advisor has such a great role in saying, "Here are the common things that people do."

So I'm not saying that you're going to do them, but you're a human being and this is really something common that people do, and so if we can think about those in advance, you're going to be a lot better, I can help you think about those things in advance and I can help you think about the luck that might get in the way in advance. And now we can make a plan. We can create a portfolio that's going to be robust against the luck, number one, right?

So we can create a portfolio that's going to perform well, this kind of going to perform well, that's kind of going to maximize the performance if the market's up and the market's down because we don't really know how the market's going to move.

So we want it to be robust against volatility, really against movement. But also, I can help you understand what are the decisions that are going to get in the way of your performance. What are the common thing that you might do that might cause this to go wrong, I'm going to help you think about those in advance, I'm going to identify them and then I'm going to be a partner with you in helping you stick to it.

John Diehl: Well Annie, that's great advice and we're drawing this podcast to a close. I want to thank you Annie, I mean, it's a very stimulating conversation but the good news is, we're not going to end it here.

And so if you've enjoyed the first – last podcast, this podcast, I'm going to – I'm going to ask you all who are listening to please tune in for our next episode where Annie and I are going to be talking about how we go from these discussions to tangible things that advisers can do with their clients, things that we can put in place to try and safeguard us against making bad decisions maybe at a point in time where we may be prone to that? Does that sound good to you, Annie?

Annie Duke: Yes, that sounds great.

John Diehl: All right. Well for all of you listening, we look forward to joining you again or your joining us again on the next episode of the Human-Centric Investing Podcast. Thanks very much.