



First Financial Group

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Most of the content of these monthly newsletters can be classified in three categories. Some of the articles are primarily informational; their purpose is to educate you about topics relevant to current trends in the financial universe. Other items are examinations and discussions of specific financial strategies – how they work, why they work, what they can be used for. The last content area covers financial philosophy, the big ideas behind that shape not only individual financial events, but also the financial actions of the national and global economy.

One of the most interesting aspects of financial philosophy is the behavioral element, how human nature often contradicts financial logic. Developing a successful financial philosophy – one that you can understand, apply and maintain – is just as important as obtaining general and specific financial knowledge. The following article highlights the significant behavioral challenges most of us face – and a philosophy that can overcome those challenges.

Taming the Invisible Gorilla

Have you heard the one about the invisible gorilla?

Two researchers created a short video of two groups of students passing a basketball to one another. The video lasted about 45 seconds and was completely unremarkable, except for one thing: About halfway through the video, an actress in a gorilla suit walked into the middle of the two groups, beat her chest a few times and walked out. The “gorilla” was on-screen for nine seconds.

Researchers asked viewers to count the number of times the basketball passed between members of one of the groups. After viewing, they were also asked if they had seen the gorilla. 50% of the respondents were so focused on counting passes *they never saw the gorilla!*

This video, first shown in 1997, is the basis for a new book *“The Invisible Gorilla and Other Ways Our Intuitions Deceive Us”* by Christopher Chabris and Daniel Simons. Full of data from various experiments similar to the gorilla video (to see this video, and others like it, you can go to <http://www.theinvisiblegorilla.com/videos.html>), the book presents a strong argument that **many of our perspectives and actions in life are distorted by “illusions.”** As a result, we either miss or misinterpret much of what is going on around us. In the authors’ words, “Indeed, virtually no realm of human behavior is untouched by everyday illusions.”

One reviewer described *The Invisible Gorilla* as “a humbling journey into the fallibility of our thinking.” Not only are we messing up, we don’t even know it.

Chabris and Simons call the illusion in the gorilla video the **Illusion of Attention**. It is our “inattention blindness” which causes us to “experience far less of our



visual world than we think we do.” But this isn’t the only type of illusion that leads us astray.

There is the **Illusion of Memory**. Our ability to recall ideas and events – even the most significant “flashbulb moments” like 9/11, our marriage ceremony, or the birth of a child – is nowhere as sharp as we think it is. Often our memories are embellishments rather than facts, like the fish that gets bigger with each telling.

Another common mistake is the **Illusion of Knowledge**. Personality assessment tests often ask respondents how many authors they have read, or which concepts seem familiar. Included in the list are fictitious names, and ideas that don’t exist. Yet, many people will claim knowledge of these non-existent people and ideas. Even when there’s no way of knowing, we still think we might have known.

Closely related is the **Illusion of Cause**. We not only think we know what happened, we think we know *why* it happened. If someone told you that every time they got a haircut the stock market went up, would you laugh or start checking their calendar? There might be a

correlation, but it's tough to think there's a causal connection between the two events, right? Of course, when someone on the business channel does the same thing comparing the Super Bowl winners and the stock market, or the price of chocolate and inflation, we think, "you know, he might be right." In reality, there are often too many causes and too many effects to think we can discern which cause triggers another effect.

Even more challenging is the **Illusion of Confidence**. As *Wall Street Journal* reviewer David Shaywitz puts it in an article from June 11, 2010, "we profoundly underestimate our capacity to be fooled." We too often associate *confidence* with *competence*; if people act confidently we assume it must be because they are good at what they do, or precise in their knowledge. But the phrase "con man" is short for "confidence man." At the heart of many poor financial decisions is misplaced confidence in an individual.



**The illusion of Attention,
The illusion of Memory,
The illusion of Knowledge,
The illusion of Cause,
The illusion of Confidence.**

Because these illusions exert such great influence over us, most of us tend to overestimate our intelligence, attractiveness, abilities, and sense of humor. At the same time we underestimate the challenges we face, and our own limited abilities to respond to them. Given these factors, **it's no surprise that we often miss what's most important, and even ignore the warning signs telling us we are headed for trouble.**

If we are all so blinded by our illusions, are good decisions impossible? Several reviews of *The Invisible Gorilla* have pointed to the practical ramifications of the findings. For example, the illusions concept offers a convincing explanation of why so many people make poor financial decisions. The illusions in *The Invisible Gorilla* offer plausible explanations for the overwhelming tendency of individual investors to buy high and sell low, or forgo disability insurance, or take a mortgage beyond their means. In fact, given the illusions that hold sway in our lives and our unawareness of them, poor financial decisions are not surprising. Rather, they are almost inevitable. How then, can individuals deal with the invisible gorillas in their lives?

Get smarter. Once you become aware of the impact of illusions on your perceptions, you can change, at least in theory. So now that you know there's a gorilla in the video, you should be able to find it, and respond appropriately.

But looking for the gorilla often means not seeing something else. As a follow-up to their 1997 video, the

authors made a new one. Like the first, this one featured two groups passing a basketball and a person in a gorilla suit. But this time, other factors changed as well. First, one group member left the stage as the gorilla entered. And during the course of the film, the background curtain changed from a deep red to gold. Viewers who knew about the gorilla and were told to count the number of passes correctly noted both items – but most missed the additional changes. Focusing on one thing precluded awareness of others.

Getting smarter helps, but even if you know more about what you're missing, it is still impossible to know it all. We simply cannot process all of the input. We can't watch every business news channel, read every financial publication, and study every report – about gorillas, or money, or anything else. We have illusions because we must filter and prioritize. So while our filters may get better, they can't catch everything.

Turn the decision-making over to someone else. In every experiment done by Chabris and Simons, some people did notice the gorilla, or caught other changes embedded in the tests. So while you might be easily fooled by the illusions of life, perhaps there are some people who aren't. If only you could find one of those "smart ones" perhaps they could help you successfully manage your financial affairs, right?

Indeed, many people have achieved great acclaim for being smarter than everyone else when it comes to money. Over time, these people seem to have a knack for knowing what to do and when to do it. Probably the best-known financial savant of our time is Warren Buffet. The "Sage of Omaha" has become one of the richest individuals in the world as the manager of the Berkshire-Hathaway investment fund. Buffet might make some mistakes, but he seems to make far less than the rest of us. Many people have done well by letting Buffet be their financial stand-in.

Unfortunately, the same thought process, of getting a smarter person to handle one's financial affairs, made it possible for Bernie Madoff to perpetuate his \$36 billion investment scam for more than 20 years. Madoff's representations of consistently above-average returns wowed potential investors and buffaloed investigators. The illusion of confidence in Madoff was so great that no one saw the underlying scam until a poor economy spurred some investors to cash out. When Madoff's Ponzi scheme started to flow in reverse, his house of cards collapsed, leaving thousands of investors with losses estimated between \$12 and \$20 billion.

This isn't meant to imply that all smart people have the potential to be con artists. Even well-intentioned people who are smarter than you may not be smart enough to avoid the pitfalls of financial illusions.

Find the perfect plan. If you can't trust yourself and you can't trust other people, then you might reason

“let’s remove the human element”. Put a system of rules in place that leaves no room for human fallibility. Get a computer to make the decisions. This is the driving idea for formulating risk-tolerance models, target funds, and all sorts of regulatory agencies.

These plans may eliminate human decision-making, but that doesn’t make them fail-safe. First, the plans were designed by individuals – you know, those people operating under illusions. All sorts of ingenious ideas and complex computer-driven models have been failures, sometimes spectacular failures.

Second, most plans, even the ones that attempt to predict the future, are based on past experiences. This backward-looking planning technique is one of the reasons financial regulation often fails to prevent abuses (like the collateralized mortgage obligations that precipitated the housing bubble). Cheaters are constantly seeking new ways to bend the rules and game the system, however regulators are constantly behind the curve. Any adjustments they make (“we can’t let this happen again!”) only reflect what would have been the perfect plan for the past, not what will be the perfect plan for the future.

Can anything tame the Invisible Gorillas? This can be depressing. You realize that you can’t trust yourself to make all of the right moves. You can’t entirely trust other people, because even with best intentions, they’re just like you. And you can’t trust finding a perfect plan, either. Given these truths, it’s almost logical to conclude that most of us are destined for financial ruin, and there’s not much we can do about it.

Risk Management: the Wabi-sabi for the Invisible Gorilla. In Japanese, the phrase “wabi-sabi” represents a comprehensive world view centered on the acceptance of transience. The Wikipedia entry says a key element of wabi-sabi is finding beauty in things which are “imperfect, impermanent and incomplete.” Accepting that it may not be possible to achieve the perfect outcome, the wabi-sabi approach looks for ways to make things work.

Given the evidence from Chabris and Simons, no one – no matter how well-informed and self-aware – can ever know enough and/or be level-headed enough to avoid making some mistakes in observation and judgment. Accepting that mistakes are unavoidable, the logical response is to prepare for them. Instead of trying to avoid all mistakes, *take steps to manage them*. Particularly in regard to your financial affairs, a risk management approach is an effective way to handle the invisible gorillas in your world, because it acknowledges that many aspects of your financial life are “imperfect, impermanent and incomplete.” For example...

If you can’t guarantee a good investment outcome, don’t put all your money in one place. If you can’t be sure you will avoid all accidents, having insurance is a no-brainer. You may anticipate steady employment, but establishing a substantial cash reserve is always a smart decision. Instead of relying exclusively on one person to help you with your financial decisions, cultivating a team of professionals can provide either a consensus, or a range of alternatives. Risk management says: In all things, hedge your bets.

It’s not an easy sell, because risk management isn’t a concept with a lot of sizzle. There’s no promise of outrageous returns, or magic formulas, or revealed secrets of the rich and famous. But risk management is the only financial approach that can handle the invisible gorillas that often lay waste to your financial aspirations.

Even if you accept the risk management paradigm, there is still a chance that these decisions may leave you slightly dissatisfied. If one fifth of your investment portfolio delivers outstanding returns, you may wish you’d invested all of it in that account. If you don’t have an auto accident or a disability claim, the insurance premiums may seem like wasted expenditures. And if everything goes your way at work, you may be tempted to use those cash reserves for a vacation to Tahiti. You begin to think, “I’ve got it figured out.” And thus the illusions of memory, knowledge, cause and confidence begin to tug at you again. The invisible gorillas are back.

A few critics of the Invisible Gorilla have said the research seems to discourage risk-taking and initiative, which are often seen as the drivers of a healthy expanding economy. After all, if everyone is incompetent, and risk management is the best response, how will any innovation ever take place?

It may seem counter-intuitive, but good risk management allows for the most risk-taking. People with a solid financial footing can afford larger risks and have a better chance of surviving failures. It is human nature, given our propensity to embrace illusions, to believe that magic formulas exist, and all of our problems would be solved if we could just find the magic formulas and apply them to our personal circumstances. But pursuing ideal illusions can get in the way of establishing workable plans. Financial risk management should be at the foundational base of every financial program. Neglecting this fundamental element is building a financial life based on illusions.

FINANCIAL RISK MANAGEMENT MAY BE “BORING,” BUT IT WORKS. HOW SOLID IS YOUR RISK MANAGEMENT PLAN?



“We profoundly underestimate our capacity to be fooled.”

DISABILITY INSURANCE: A Case Study in Illusions?

“Even if I get disabled, I’ll still work.”

Huh? How is that possible?



Ask any insurance agent who’s been in the business for awhile, and chances are, he/she has heard this statement, or a variation of it. That’s because disability is one financial topic where illusions often prevail over the facts.

For most non-retirees, their ability to earn an income is their greatest financial asset. Compensation from work puts food on the table, pays the mortgage, sends kids to college, and builds the retirement nest egg. Without an income, none of that happens. It should be easy to recognize the desirability of good risk management strategies for disability, right?

Wrong. Just like the findings in *The Invisible Gorilla*, **people underestimate the risk of disability and overestimate the abilities and resources available to handle it.** Consider these statistics:

- The government’s Social Security Administration (SSA), which provides disability benefits for most Americans, says that three in 10 people entering the workforce today will become disabled before retiring.*
- SSA also reports that the overall rate of disability is increasing among both men and women workers. In 1999, 3.6% of covered workers were receiving Social Security Disability Income payments, while in 2009, 5.1% were receiving SSDI payments. Factors behind this dramatic rise include the aging of the U.S. workforce and the recent poor economic conditions.**

When 5% of Americans are on disability claim and 30% are likely to experience a period of disability before retirement, this sounds like a situation that should be addressed. And in some ways, it is: Social Security offers some insurance, as does Workers’ Compensation, which provides benefits for disabilities occurring in the workplace. But do these programs really provide adequate risk management for disability? Again, look at the numbers:

- The Council for Disability Awareness** (CDA), an association of 16 insurance companies that comprise 75% of the commercial disability insurance marketplace, reports that 95% of all CDA Member Company disability claims are not work-related. For the SSA, 90% of all disabilities are not work-related.
- 31.2% of individuals who received long-term disability benefits from CDA Member Companies** in 2009 did not qualify for disability benefits from Social Security. While the number of workers receiving Social Security benefits has increased, only 35% of workers applying for SSDI disability claim payments in 2009 were approved; 10 years ago, the approval rate for workers applying for disability was 52%.

- In spite of the limited protection afforded by Social Security and Workers’ Compensation, the US Bureau of Labor Statistics reported in an April 29, 2010 press release* that 46% of full-time workers had short-term disability benefits and only 39% had signed up for long-term disability.

The conclusion: Many of the disabling incidents that could keep you from earning an income are not going to result in payments from either SSA or Worker’s Compensation. And half of all workers don’t have any other coverage. How does this happen?

“Many people recognize the emotional and financial impact of becoming disabled, but they tend to underestimate the consequences of not having adequate income protection,” according to insurance company vice president Kevin Farley***. Instead of insurance, they think they can rely on their savings, make adjustments in lifestyle, and get help from family members.

But mostly, people think they can define the terms of their disability. They will say...

“If that happened to me, I could still go to work.”

or...

“I wouldn’t be out that long. I’m a fast healer.”

and...

“I’m not one of those people who would milk an insurance claim.”

Hmmm. It sounds like these people are operating under some illusions. They minimize the impact of a disability, often because they underestimate the likelihood of it occurring while overestimating their ability to withstand the financial consequences.

*April 29, 2010 Press Release from *Business Wire*, “Most Americans Live to Work But Don’t Prepare for Illness or Injury That Could Put Their Income at Risk.”

**www.disabilitycanhappen.org

****Business Wire* from Principal Financial “Despite Fears, Americans aren’t Protecting Themselves,” May 14, 2010.

SHOULD A SECOND HOME BE THE ONLY ONE YOU OWN?

It’s too early to make a definitive statement, but the fallout from the real-estate bubble may result in some fundamental long-lasting changes in Americans’ perspectives on home ownership. Not only is there the chance that fewer Americans will be able to own a house, but even those who are prime candidates for home ownership may find other options more attractive and financially profitable.



A little background:

Before 1940, slightly less than half of all American households owned a home, a percentage that had remained unchanged for more than four decades.

Following World War II, the Baby Boom, coupled with government tax breaks and subsidies, rapidly increased the percentage of Americans who owned their house¹. By 1960, more than 60% of Americans were homeowners, and for a period in the late 1990s and early 2000s, the number approached 70%.² Homeownership became a standard fixture in the American Dream.

However, the allure of homeownership has lost much of its luster in the recent financial melt-down, both for homeowners and the financial institutions who initiated the mortgages to make the purchases possible. Where once only a few financial commentators questioned the financial value of owning a home, a tide of commentary is asking if the US economy would be better off with fewer homeowners and more renters. But maybe the problem isn't how many people own a home, but what type of home they own.

When the housing market was booming through the past two decades, it was assumed that almost every homeowner could expect to cash out with relative ease, either by selling the house or taking a home equity loan. Home equity was seen as a liquid real asset, one that could be accessed at almost any time.

However, as banks have tightened their lending standards to potential homeowners, the market of potential buyers has shrunk, driving prices down. At the same time, more homes are being liquidated at discount in foreclosures and short sales, further depressing the market. In the course of the past three years, current homeowners find their home equity has substantially diminished – and isn't very liquid.

These changes in the real estate market increasingly make homeownership a much longer term proposition. A decision to buy a home today isn't easily undone. For those who currently own a home, it may take awhile for values to rebound, and selling the home in the future is no longer a foregone conclusion, even at reduced prices. This fundamental change in perspective regarding homeownership should compel individuals to consider questions like:

- Is there a profitable exit strategy for this house, or should I plan to live here for the rest of my life?
- What happens if an employment change requires a relocation?
- What is the projected market for my property in the future?
- What is the legacy value of my home? Is this an asset my heirs will want to inherit?

In the past half-century, the largest increase in American residential housing has been in suburban communities, and the bulk of the middle-class homeowners own single-residence dwellings in subdivisions. If you are one of these suburban homeowners, how would you answer the questions above? Can you see yourself staying in this house for the next 20 or 30 years, or into retirement? Would someone else want to live in your subdivision? And if your children or other heirs inherit this property, will they see it as a valued asset or a financial albatross?

When you consider the changing demographics of an aging population, a post-Baby Boom contraction in housing demand for single-family homes, and fewer financially-qualified home buyers, it is reasonable to think the long-term prospects for suburban housing won't be what they have been for the past 50 years. If this is true, a different approach to homeownership might have some appeal.

A different approach.

Instead of a single-family house as the default option for real estate, look at other options. For example, think about renting a primary residence and buying a “second home” – such as a cottage, a vacation or resort property, or even an income property in a thriving community. Under the right conditions, this strategy could have

several advantages.

First, many buyers of a “second home” property could still receive tax advantages that would closely approximate those that come from owning a primary residence. Second, income from rentals (seasonally on resort properties, or year-round in residential locales) may offset many of the costs of ownership. Third, resort and vacation properties can be enjoyed by owners and their families for their recreation and destination value, both now and in the future. Fourth, renting may offer greater flexibility in adjusting to fluctuating living conditions, such as changes in employment or children leaving the nest. Fifth, if it is desirable to make this property a home in retirement, the transition is simple; you stop renting and move into the house. Sixth, a profitable rental or desirable vacation home would likely have ongoing value for heirs; a sale would not be required for them to receive value from the inheritance.

This strategy of buying a “leisure home,” while living in a rental is not a new idea. This pattern was typical of many wealthy individuals during the late 19th and early 20th century. They owned an “estate” in the country, and rented a workplace residence. American steel magnate and finance giant Andrew Carnegie (1835-1919) was one of the richest men in history, and he established his fortune quite early in life. When he was in his twenties, Carnegie erected a large estate home on property in



U.S. Census Bureau:

¹1989 report, *Historical Statistics: Colonial Times to 1970*.

²US Census Report, *Homeownership by Area* (focusing on homeownership from 1960-2008)

Homewood, PA, near his hometown of Pittsburgh. Yet for much of the next 25 years, Carnegie resided in luxury hotels in New York City, returning to his estate during the summers or as a stop on his travels. At various times, other members of Carnegie's family also lived at the estate, but it was never Carnegie's exclusive residence. In later life, Carnegie established additional large estates in Massachusetts, Georgia and Scotland.

In several ways, the "titans of industry" during the Industrial Revolution mimic some of the work circumstances of people in the 21st century Information Age. Carnegie and other businesspeople of his era were establishing continent-spanning businesses that required them to be mobile. Even though some employers may offer telecommuting options, today's workforce opportunities often require a high level of transience. Today's worker expects to change jobs more often, and to change their places of residence as well. While any relocation is stressful, it could be argued that renting makes moving easier from a financial perspective – there is no home to sell, no monthly mortgage payment on an empty home, and there is no equity loss to worry about.

At the same time, buying an "estate property" offers several tangible and financial benefits, both now and in the future. A well-managed income property has the potential to add revenue to your financial program. A vacation home can be a welcome getaway and a gathering place for families as they grow up and expand. In both instances, the need to sell will be lessened, which allows more time for equity appreciation, and gives owners the upper hand in deciding when and if a sale should take place. If this property stays in the family for

several generations, the long-term benefit of buying estate property could be incalculable. As the turmoil from the Great Recession recedes, the fallout is revealing changes in the financial landscape. Those changes may affect the role of homeownership in the American dream. While single-family residences may still occupy a prominent place in the financial lives of many Americans, it doesn't hurt to consider (and prepare) for other options.

DO YOUR LONG TERM FINANCIAL PLANS INCLUDE "ESTATE PROPERTY?"

IF YOU FOUND AN ESTATE PROPERTY OPPORTUNITY, HOW WOULD YOU EXECUTE THE TRANSACTION?

WOULD YOU LIKE TO EXPLORE THESE, OR OTHER IDEAS WITH US?

"A man with a surplus can control circumstances, but a man without a surplus is controlled by them, and often has no opportunity to exercise judgment."



- Marshall Field

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