Seven Myths About Money

And the *truth* about finding financial freedom

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Preview chapter – Exclusive to the launch team!

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(And forgive any mistakes – it hasn't been fully edited yet!)

The Myth: *The correct way to invest involves reducing risk as much as possible.*

The Reality: *There is no 'correct' way to invest – it's up to you to find an approach that matches your motivations (including the one that traditional models ignore).*

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Chapter 3 {Ch No}

The Risk-Minimisation Myth {Ch}

In 2005, Ashvin Chhabra was wrestling with a question: given that the 'optimal' way of structuring an investment portfolio had been known for over fifty years, why did no one actually use it?

Chhabra was an executive at the investment bank Merrill Lynch, and would go on to manage the money of one of the world's most successful investors and biggest philanthropists.[i] Many of the bank's clients had, by any reasonable measure, already won the game of money – and given that they were taking professional advice, you might expect their investments to be a case study in sober, sensible risk reduction.

Not a bit of it. No matter how financially sophisticated, these wealthy clients were just as emotional about money as anyone else. When the market was crashing, they rushed for safety and wanted to sell. When the market was booming, they got greedy. And even though they could pretty much stick their money in a savings account and live off the interest, they continued to take risks.

This isn't a dysfunction of the wealthy few with an insatiable lust for more: there's no shortage of people who politely nod along as a financial advisor recommends investing in a carefully crafted selection of stocks and bonds, only to rush out to find a house to flip for a quick profit.

This is because while there is a mathematically 'correct' way to invest, it doesn't fully represent what people really want. Yet, as Chhabra eventually found, there is a completely different approach to investment – one that doesn't imply there's a right answer to be found, but rather appreciates that every investor is looking for something different.

The three money motivations {A}

The textbook way to invest that Chhabra had learnt was developed by Harry Markowitz in 1952. Markowitz, essentially, used all manner of fancy maths to work out how an investor should maximise their return without taking on an unacceptable amount of risk. 'Risk', in this

model, is the same as ‘volatility’ – meaning swings in performance from year to year. According to the model, shooting for higher returns involves opening yourself up to more volatility (or risk), so each investor should focus on finding the ‘sweet spot’ where the return they achieve is as high as possible, but stop short of the point where the sleepless nights would kick in. The working assumption was that every investor wanted the smoothest possible ride and would only take on additional risk if they absolutely needed to.

At the time, modelling this trade-off mathematically was a major breakthrough, and would eventually earn Markowitz the Nobel Prize for Economics in 1990. Since its publication, it’s become firmly established as the bedrock of how professional investment portfolios are built.

Yet while it was a valuable contribution to the attempt to solve the investment puzzle, it doesn’t come close to addressing how people think about money in the real world. Sure, most of us would prefer an investment that grows in value by a steady, predictable amount rather than one that lurches sickeningly around all over the place – but volatility isn’t the only risk. What about the risk of your assets being tied up so you can’t access them when you want to? Or that some unforeseen catastrophe means your returns deviate dramatically from those predicted by the model, leaving you high and dry? In the Markowitz model these ‘downside risks’ don’t get a look in.

Chhabra noticed something else crucial: as well as the risk of losing, there’s such a thing as the risk of ‘failing to win’. In other words, even though his bank’s clients were already life’s winners (having so much wealth you need someone to help you manage it is the definition of ‘nice problem to have’), they weren’t preoccupied with avoiding loss. Rationally – and the Markowitz model makes the assumption that investors are rational – they needed merely to avoid doing something very stupid and they’d be able to live a comfortable life for ever. And yet they still wanted to *win*.

This ‘winning’ motivation – the drive to improve their financial standing, even from a starting position comfortably within the top 1 per cent – was what Chhabra identified as being missing from most financial planning. And if the already-wealthy wanted to win, surely that would also be the case for those further down the wealth distribution ladder, where the results would be more directly life-changing.

In fact, Chhabra identified that there were three separate and competing motivations present in every investor’s mind:

{list}

- **Protect** against disaster (‘personal risk’)

- **Maintain** your lifestyle ('market risk')
- **Improve** your financial status ('aspirational risk')

{list}

These three motivations aren't listed in order of importance: everyone has them in different proportions, and they even vary in importance for the same individual over time. The key point is that everyone has, to some degree, all the motivations all the time.

Markowitz focused on the second of these: you could use his model to maintain your lifestyle by solving market risk in the neatest way possible, and if you wanted protection you could get that from cash. Where Chhabra was unique was recognising that, for many people – regardless of wealth level – the third risk of not achieving their aspirational goals was very real, and needed to be balanced alongside the other two.

This explains why billionaires continue to make risky investments when they could live perfectly well without ever earning another penny: they want to keep on winning, and gain ground among their rarefied peer group. After all, how can life be bearable on a 60ft yacht if all your friends suddenly have 80ft yachts with a helipad?

Chhabra's write-up of his research has been cited in later academic papers fewer than a thousand times, compared to Markowitz's 66,000 (and Nobel medal). But I've made it the cornerstone of how I think about investing – and I believe it's more important today than ever before.

During the era of guaranteed final-salary pensions and affordable houses, 'average' was pretty good. Of course, everyone would still like to do better if they could, but if being slap-bang in the middle of the income distribution guaranteed you a paid-off house, a couple of holidays per year and a comfortable retirement? Well, for the more risk-averse members of society that would dampen down the desire to take any chances with the aim of making a big leap upwards.

But in recent years the quality of 'average' has deteriorated: the typical person is less likely to be able to own a home near the start of their working life, less likely to have an adequately funded pension at the end, and their household is more likely to require two incomes to get by.

Then there's investment returns. From 1972 until 2019, an investor in a 60/40 mix of global stocks and bonds would have enjoyed an average annual return of 7.5 per cent, with a standard deviation – a classic measure of volatility – of 10.3 per cent. The most rewarding part of this period coincided with the age of free money: between 2008 until 2020, when most

global interest rates were close to zero, investment returns reached as high as 9.6 per cent with barely any rise in volatility.

But this era is gone. From 2020 until mid-2024, the average return from the same portfolio fell to 5.1 per cent while volatility increased to 14 per cent. In this new economic environment – with likely lower investment returns, and less ability to invest at all because the cost of everyday life leaves little left over – more people may feel the motivation to turn up the 'improve' dial. They have less to worry about losing, and staying where they are feels a lot less appealing. This explains why so many young people have been YOLO-ing into meme stocks, and it might not be as irrational as it seems: they might be looking at the vast gap between their grim prospects and what they aspire to, and deciding it's more scary to be stuck where they are than to risk losing some money and be set further back.

These are the sorts of tough choices ever more people will need to make. It will be a rare person who can invest enough to simultaneously assure their safety, make incremental gains, and still have some left over to risk on securing a big win. In our new era, the three motivations have never been harder to balance – and it's never been more important to understand them.

Understanding the three motivations {A}

Let's dig a bit deeper into each of the three motivations. You'll certainly relate to one more than the others, but you should recognise all of them within yourself to at least some extent.

Motivation #1: Protect against disaster {B}

You don't want to end up having to drastically cut back if you lose your job, if you get ill, or if the economy takes an unprecedented dive. In short, you don't want your financial life to be fragile: you want to put a bit of bubble wrap around it, so you can take some knocks throughout the journey.

For one person, a setback might mean the risk of ending up on a friend's sofa. For another, it might mean yanking the kids out of private school. One is objectively worse than the other, but both will feel painful to the individuals involved: any reduction in lifestyle hurts, even if you're starting from a privileged position.

You therefore want a plan that gives you the near certainty of safety: any upside would be lovely, but not if it risks you taking a big fall from where you are now.

Motivation #2: Maintain your lifestyle {B}

Wouldn't it be great to ditch work completely without having to cut back at all? This is the motivation to maintain your lifestyle, even as you ease off on work – using investment income to replace the income you earn.

Even if we're at peace with the idea of earning money for longer without necessarily retiring, most of us would still like at least the option of stopping work completely and continuing to enjoy the same home, holidays and leisure we do now. And, of course, although it may not be pleasant to think about, there will come a point when we're unable to work at all. So, just as we want near certainty of being protected, we also want a high probability of being able to maintain our lifestyle late in life: any plan that offers just a 50/50 chance would be entirely unacceptable.

Traditional investment portfolios, paired with the protection of owning a house, are designed to get you to that point slowly, predictably and unexcitingly by compounding gradually over time. The smaller the swings in your net worth from year to year along the way, the more successful a financial professional would consider the plan to be.

These two motivations are worthy aims, and I can't imagine anyone who wouldn't want to achieve both. But as Chhabra found, most of us also aspire to something more.

Motivation #3: Improve your life {B}

Nobody plays the lottery because they dream of being able to think 'Wow, I guess I'm really safe now!' They also want to move to a bigger house in a nicer area, take more holidays and buy fancier stuff. Some feel the desire to improve their lifestyle more than others, but it's a rare person who's 100 per cent content with what they have and wouldn't be even the tiniest bit interested in giving their life an upgrade.

If we're being honest with ourselves, we also want to improve our position relative to our peers. The American journalist H. L. Mencken once quipped that a wealthy man is one who earns $100 a year more than his wife's sister's husband – and academic research suggests that he was more correct than he might have realised. 'Social comparison theory', pioneered by Leon Festinger in the 1950s, describes the fact that poor people can be happier than wealthy people if they're relatively well-off by the standards of their surroundings. In 2021, Michael Kraus and Jacinth Tan replicated this finding by analysing studies with a total of 2.3 million

participants. They showed conclusively that doing objectively well isn't enough, and nor is improving over time or having a better life than your parents: to be happy, you need to be doing at least as well as your peers. In other words, we're all motivated to make a leap up the income distribution scale.

Unfortunately, this pretty much dooms us to perpetual dissatisfaction, because if you suspect that you're surrounded by people who are richer, happier and better looking than you are . . . you're probably right. In fact, this is a phenomenon that has been scientifically proven too, in this case by network scientists Young-Ho Eorn and Hang-Hyun Jo. In 2014, the pair introduced what they call the 'generalised friendship paradox'. The paradox is this: most of us have a small number of friends, but a small number of people have a much larger number. It tends to be the case that the people with a larger number of friends also tend to be the ones who are wealthier and happier. As a consequence, each of us is dramatically more likely to find ourselves hanging out with the wealthier, happier people than with more representative types – because it's the rich, happy people who tend to have the biggest networks. Cue endless negative comparisons with our millionaire friends.

All this means that the drive to be more successful than your peers is every bit as deep-rooted as the desire to protect yourself from disaster. But if you confess your hankering to fly first class or start shopping at Harrods to a financial advisor, they're likely to politely redirect you towards a projection of retirement annuity rates and start talking about life insurance.

This is partly because striving to improve your lifestyle involves taking on some degree of risk – and as we've seen, their models tell them that risk is solely there to be minimised. It's also because it's exceptionally difficult to give advice about making big financial leaps. Why so tough? Well, there are a thousand different ways of achieving it, depending on your individual skills and preferences. You can't just tweak a few variables and point to a plan that will suit almost everyone, accompanied by reassuring historical data to show how well it would have done in the past. There's also no guarantee it will work at all: while we demand a high probability of success from the other motivations, significantly improving our financial standing is never going to be more than an alluring possibility. What's more, there's a risk that if we push too hard, we could jeopardise the other two critical motivations.

So it's understandable that this motivation ends up being ignored, but it's a problem – because the important psychological need for striving, improvement and winning isn't being met. It explains why it isn't hard to imagine someone nodding sagely along to the most softly-softly advice in *The Richest Man In Babylon* before flicking across to their investment app and buying the latest hot stock they saw mentioned in their group chat. Anyone with the

ambition to improve their status in life – which includes, at the last count, pretty much everyone – is left to figure it out on their own.

The only investment decision you need to make {A}

Thankfully, by acknowledging and understanding these three competing motivations, we hold the key to radically simplifying our investment decisions. That's because any investment you make will serve one – and only one – of the three motivations.

For example, a cash emergency fund serves the motivation to 'protect'. A speculative investment in a new cryptocurrency is very much powering the drive to 'improve'. It gets more granular too: a diversified mix of stock market investments ticks the 'maintain' box, whereas holding shares in a single company in the hopes it'll shoot up in value is 'improve' all the way.

Once you start seeing the world in this way it makes your investing life almost ridiculously simple, because it reduces the whole complicated business to just one decision: how do I want to balance each of the three motivations?

That's because finding the right balance between these 'buckets' is vastly more important than what you have within each bucket. For example: should you buy your home, or invest in short-term government bonds, or just keep your cash in the bank? Well, as we'll see, they're all 'protect' assets – so if that's the bucket you want to fill, which you pick doesn't matter all that much. Any of them will suit you better than buying an investment property with a mortgage, which falls under 'improve'. It's a bit like choosing between a holiday in Spain, Saint Lucia or the Seychelles: you might prefer one to the others, but they'll all be far better than Siberia if you're in the mood for a beach holiday.

Let's not get carried away, though: just because we've reduced investing to a single decision doesn't mean it's going to be an easy one. How should you be sizing each of those buckets? I have some practical pointers to share – but, first, it's worth looking at some of the factors we need to consider.

The first is where you're starting from. The wealthier you are, the more risks you can afford to take. A billionaire could comfortably have 80 per cent of their assets in the risky 'Improve' bucket. Why? Because 20 per cent of a billion (200 million) invested in the safer buckets would easily be enough to keep them (and their yachts) afloat if everything else went wrong. That doesn't mean all billionaires should take this kind of risk – becoming relatively

worse off is painful even if you're still richer than 99.99 per cent of other people. The point is that the more you're starting with, the more risks you can take if you want to.

Then there's your age – or more accurately, your earning potential. Most financial advice is tailored by age, and to an extent this makes sense. Having 20 per cent of your portfolio's value wiped out by some misfortune when you're twenty-five years old is no fun – but at sixty-five years old, when you're on the cusp of retirement, it could be disastrous. As a result, the typical investing advice you'll receive is to gradually shift the balance of your portfolio away from risk as you get older. The trouble is that this approach is a tad simplistic. It's not age that matters, really, but future earnings.

Clearly, as a shortcut, a twenty-year-old is likely to generate more future earnings than a sixty-year-old. In reality, though, two people in their twenties can be on entirely different financial trajectories. Based on age alone, you'd give them both the same financial plan – probably involving building up some savings ('Protect') before making cautious, low-risk investments ('Maintain'). But as it turns out, one of these people is a newly qualified doctor. She has millions of pounds of future earning potential, so she can afford to take some aggressive risks with her money. Even if she loses it all, she potentially has decades of high earnings ahead to make sure she recovers. The other person has no qualifications, and is working in a minimum-wage job. It's still possible for him to end up wealthy (perhaps by starting a business), but he just can't afford to take the same financial risks right now.

Of course, our future doctor might not want to take that kind of risk. That's where the next factor comes in: your fear of loss versus desire for gain.

For example, let's toss a coin. If it comes up 'heads', I'll double whatever cash you have in your bank account right now. But if it lands on 'tails', I'll take half of your bank balance away. This is a good deal in that you stand to gain twice as much as you'd lose. But would you take the bet?

The evidence indicates that most people wouldn't – because we're hard-wired to be more scared of losing money than we're excited by gaining it. This phenomenon – 'loss aversion' – was famously demonstrated by the behavioural economists Amos Tversky and Daniel Kahneman in the 1990s, and is often used to demonstrate that humans are irrational and subject to biases when it comes to investing. However, it only holds for people on average: different people's psychology around money varies wildly.

You can be a risk-taking billionaire or a fearful one. A risk-taking penniless student or a fearful one. There's no right or wrong attitude: it's just a result of how you're wired and the

life experiences you've had. But it's worth knowing, because it'll cause you no end of stress if you adopt an approach to investing that's not aligned with your risk tolerance.

How to make the one decision {A}

Over the next few chapters, we'll be taking a deeper dive into the assets that fall within each of the three buckets. After that, you'll feel better equipped to decide how much to allocate between each – and when we get there, we'll revisit this question. But it's worth starting with a rough idea now, and I personally think of it in terms of different 'shapes' – each suiting a different type of person and life goal.

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The pyramid. The largest share of your investments is in the Protect bucket, followed by Maintain, with a small slice of Improve at the top of the pyramid. This is a common shape that tends to suit people who are happy enough with where they are. They want to stay there without taking much risk, yet without completely giving up on the possibility of a significant change for the better.

The barbell. You have the safety of your own home giving you a chunky Protect bucket and, knowing that at least you'll always have a roof over your head, you choose to scrimp on Maintain. Instead, you put the remainder of your cash into Improve assets that attempt to move the needle.

The fat middle. You don't own a home (making for a small Protect bucket), and the majority of your investments are of the Maintain variety – with a small amount of Improve on top.

The 'T'. Minimal Protect, no Maintain, and almost everything in Improve. This is as risky as it gets, and suits either someone without much to lose or with a burning desire to strike it rich.

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You'll probably find yourself drawn to one of these more than others. But if you don't have a clue which suits you best, it can help to go through the buckets one by one.

Let's start with Improve. A good question to ask yourself is: how much of a risk of loss am I willing to accept in exchange for a shot at a significant gain? Another way of phrasing this, which forces you to face the worst case head-on, is: 'how much would I be willing and able to lose completely?'

At the other end of the spectrum, the size of your Protect bucket will be largely determined by whether you own a home – and whether you want to in the future. Unless you're already wealthy (or, more optimistically, 'until' you're wealthy), the value of your home minus the value of your mortgage will represent a large proportion of your assets. If you're saving up for a home, any cash that forms part of those savings will also form part of your Protect bucket – along with your emergency fund and general savings.

As we'll see in the next chapter, home ownership isn't necessarily right for everyone. If you don't want to own a home in the near future, your Protect bucket will inevitably be smaller – but as you'll have less certainty over your living situation, you might want to balance this out with a larger emergency fund. With these two buckets determined, everything that's left over can be allocated to Maintain.

Important though this decision is, you don't want to overthink it. There's no point removing the 'what should I invest in?' stress only to replace it with 'what size should my buckets be?' stress. It will always be a rough guide rather than an exact target, and it will be continually changing: this may be the only investment decision you need to make but it's one you'll need to revisit on a regular basis.

Keeping it simple {A}

The power of the three motivations lies in the way they simplify investing. Even if you can't decide on quite how to balance your three motivations right now, having it as a framework allows you to sidestep a lot of complexity, guilt-free.

And the financial world does love to throw complexity at you. If you decide to invest in the financial markets via an ETF (exchange-traded fund) – supposedly the 'simple' choice – you'll find that there are, in the UK, 1,647 different options. And should you be evaluating competing investments based on their APR, APY, CAGR or IRR? The investment industry seems to believe that you know and care what these abbreviations mean, but don't worry – few people do.

Ultimately, if your bucket sizes are wrong, none of this complexity matters anyway: you won't be satisfied with the outcome, because you'll either fall short of your dreams or be kept up at night by fear. And if your bucket sizes are right, no amount of studying comparison tables or trying to figure out what on earth a 'Sharpe ratio' is will result in a meaningful improvement.

The catch is that knowing what you truly want – and which painful trade-offs you're willing to accept to get it – is more mind-bending than trying to calculate the equations that underlie Modern Portfolio Theory by hand. You won't get it exactly right, and your preferences and attitudes will change over time. But merely by trying, you cut through an incredible amount of noise – and are vastly more likely to be satisfied with where you end up.