September 2008 *MoneyMinute* – Why We Worry About the Wrong Things

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From time to time we like to pass on wisdom from our favorite experts in the financial planning world. Returning to MoneyMinute this month is Nick Murray, author of *Simple Wealth, Inevitable Wealth*.

The Availability Fallacy
By Nick Murray

I am sitting in a first-class seat on a flight from New York to Los Angeles, a distance of some 2,600 miles. You are driving on the Long Island Expressway from its starting point in Queens to its end in Riverhead, New York — a distance of some 70 miles. Which of us is more likely to be killed before we reach our destination? And (for extra credit on the quiz) what is the mathematical relationship between the two probabilities?

The answer, of course, is that you are one thousand times more likely to buy the farm on your trip than I am on mine.

But it doesn't feel that way, does it? A plane crash is everybody's worst nightmare. On those exquisitely rare occasions that one happens, it will dominate TV news for days -- unless, like the time the Concorde crashed, it's on for weeks. A car wreck, psychologically, is something that happens to someone else. And, unless it's particularly horrific, it won't be covered in the media at all. So, because of its immediacy and terror, we intuitively regard death in a plane crash as being much more likely than in a car, when the opposite is overwhelmingly more probable.

This is simply the most obvious example of a systematic mental lapse that the psychologist who postulated it — the late Amos Tversky — called the availability heuristic. (A "heuristic," in the jargon of behavioral psychology, is a consistent misapprehension of probability by a significant percentage of the population. For instance, if we flip a coin ten times and it comes up heads every time, we are strongly inclined to the belief that that the odds are overwhelming that it will come up tails on the eleventh flip. Instead, every flip is 50-50.) For purposes of this discussion, since neither of us is a Ph.D. in psychology, I wonder if we might just call it "the availability fallacy."

The availability fallacy is very powerfully at work in people's perceptions of financial risk. For instance:

All of us have seen a one-day, 23% decline in the S&P 500, on October 19, 1987. But none of us has ever seen a one-day — or even a one-year — 23% increase in the Consumer Price Index. (Even in highly inflationary periods since WWII, that's taken two years.) Market volatility is, by its nature, sharp, sudden and terrifying. Erosion of purchasing power is slow, insidious, constant … and all but invisible on any given day.

For this and myriad other reasons, Americans vastly overestimate the probability that equities will cause them to suffer catastrophic principal loss. And they even more abysmally underestimate the probability that, over three decades of retirement, erosion of purchasing power will grind down their lifestyle. This is the availability fallacy at its most dangerous.

The wise investor will constantly remind himself of this. One way is to remember that markets can and do go down suddenly and significantly ... but they've never stayed down. There have, in fact, been three howling bear markets since the 1987 event — in 1990- 91, 1998, and the great-grandfather of all postwar bears in 2000-2002. Yet the S&P is today about seven times higher than it was at the end of the 1987 decline. The effect of the declines has been negligible to nonexistent, in the career of the long-term investor.

By the same token, inflation very rarely goes up much in any one year... but it virtually never stops going up. The cumulative effect of this observation may clearly be seen, if you simply juxtapose a 15-cent first-class U.S. postage stamp issued to celebrate the 1980 summer Olympics with a brand new Frank Sinatra commemorative 42-cent stamp.

In 1980, again in 1987, and again in 2008: the long-term, planning-oriented investor was and is well-advised to worry much less about loss of principal than about erosion of purchasing power. The availability fallacy causes most people to do the opposite. Don't be one of them.

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