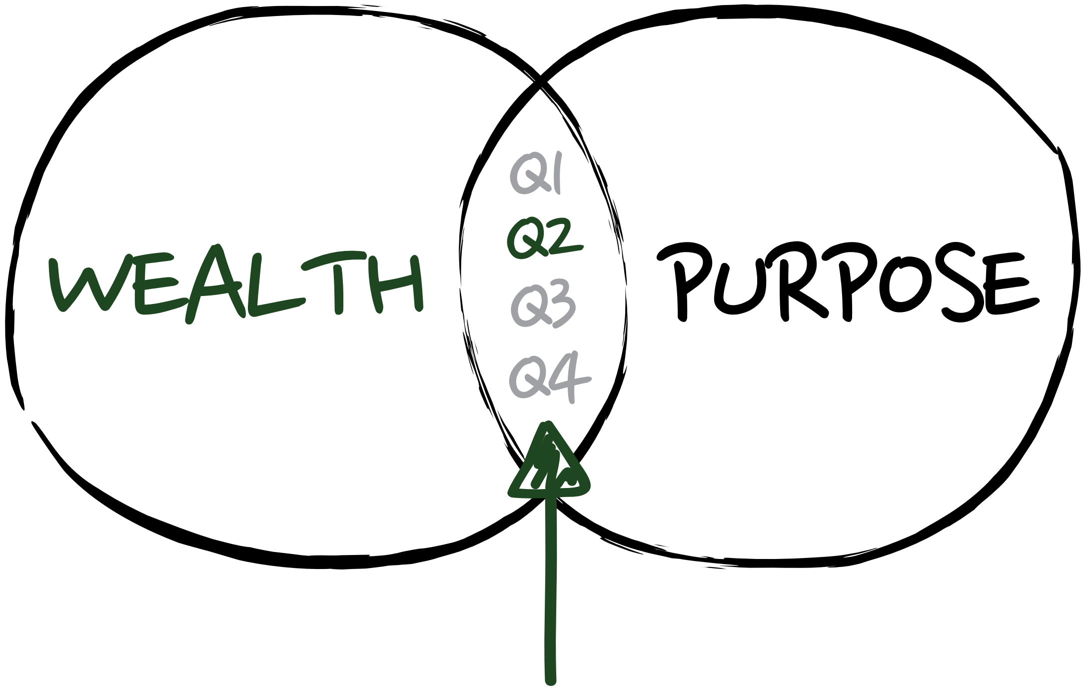

CONNECTING QUARTERLY

MAY 2018

Dear Friends,

Willpower, or lack thereof, affects us every hour of our lives. Its effect can be seen in our health, our relationships and our wealth. Many believe that something so psychological and influential must be part of our DNA; that we are either born with strong willpower, or we're not. But 50 years ago, a psychologist at Stanford University found a startling conclusion about willpower that I think we can each use to our benefit.

In the late 1960s, Dr. Walther Mischel began what became a groundbreaking experiment on the topic of willpower. Using 4- and 5-year old children as his subjects, he took each child into a room and had them sit in a chair. He then showed the child a tray that had three marshmallows on it: one on the left side of the tray and two on the right. He told the child he was going to leave the room for an undefined period and told them they could eat the single marshmallow if they liked. However, if they waited for him to return to the room before eating the single marshmallow, they could have two marshmallows to eat.

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Not surprisingly, Dr. Mischel found variations in the willpower of different children. Some ate the first marshmallow before he was even out the door, while others resisted temptation for a long time until he finally returned to the room and allowed them to eat the two marshmallows. The more interesting discovery Dr. Mischel made was that willpower was not some sort of innate personality characteristic. Rather, we can shape and improve it with some relatively simple techniques. As he describes in a 2014 interview[1]:

> *The little girl is waiting with exactly the set up that we just talked about. (The marshmallows are) exposed in front of her and she (eats the single marshmallow) within 60 seconds after a bit of a struggle. We run the same child again in a situation where we say to her before we leave the room, "if you want to…you can make believe that it's not really there. You can make believe it's just a picture. You know what a picture is". And the little girl says to me, "yes, it's something with a frame around it".*
>
> *And I say to her "put a frame around it in your head". And the child is able to wait 15 minutes. So what did we learn from that? We learned that the way in which the temptation is mentally represented makes a huge difference.*

What Dr. Mischel found, in his words, is that all of us have both a "hot brain" and a "cool brain". Our hot brain is instinctual; it has been honed since prehistoric times to react very quickly; to do things that keep us alive when faced with immediate danger. It helps us to make quick decisions, but in complex situations it can often lead us to incorrect decisions. Our cool brain is the opposite; it is logical and calculating and used to solve complex problems, but it often takes a significant, conscious effort for us to engage it. Dr. Mischel found that if 4-year-olds could put an imaginary frame around a marshmallow and turn it into an object that was psychologically distant, they could learn to engage their cool brain, resist temptation and improve their outcomes.

Like the children in Dr. Mischel's study, personal financial decisions often force us to choose between short-term gratification and the desire to achieve a long-term outcome: Should I sell all my stocks because the market has recently declined 20%, or continue to stay the course? Should I buy the expensive vacation home that just came up for sale on my favorite stretch of beach, or continue to rent every summer? Should I emulate my friend and put all my money into Amazon and Netflix stock, or maintain my globally diversified portfolio?

Just like the question of whether two marshmallows are better than one, these are all situations where making a decision without engaging our "cool brain" is likely to be dangerous. However, we can use aspects of Dr. Mischel's findings to help improve our ability to make financial decisions:

1. **Ignore external stimuli that are not aligned with our goals.** Stop paying attention to the financial media altogether. The print and web "news" outlets are NOT sources of advice. They are providers of entertainment, compensated by advertisers, seeking solely to capture our eyeballs and brains with a continuous stream of addictive sensational ideas. Do not let these entertainers stimulate our emotional "hot brains".

2. **Paint a different mental "frame" around the object we covet so as to produce a different emotion.** Rather than envisioning ourselves sipping a cocktail while watching the waves from the sun-drenched deck of the beach house (that we can't really afford), we could imagine the calls to the water restoration company to repair the damage from the water heater that leaked during the "off season". Instead of imagining Amazon as repeating its fantastic gains of the past, imagine it

becoming the next Enron or WorldCom, real-life examples of the pain and regret that concentrated bets on single stocks can bring.[2]

3. **Paint a different "frame" around the concept of investing in general.** Rather than thinking about the daily gyrations of a mutual fund as dollars flowing into or out of our pockets, think about being a long-term owner of the hundreds or thousands of businesses that we own. As investors, we hope to convert our ownership in those businesses to money at a later, perhaps even distant, date in the future. But today, rather than stressing about the fact that the market might be assigning a value to those companies that is 20% lower than last quarter's value, we could instead choose to think about all the goods, services and profits produced by the companies we own. Thinking about the health and the activities of the actual businesses will probably make us less likely to make the potential mistake of selling them during a market decline.

According to neuroscientist Antonio Damasio, every decision we make, whether it involves marshmallows or investments, is rooted in our emotions[3]. However, work by scientists like Dr. Mischel suggests we can change the way we think about financial decisions to produce emotions that are better aligned with our long-term goals.

Sincerely,

Chuck Carroll, CFA, CAIA
Chief Investment Officer
TFO Phoenix, Inc.

[1] "Walter Mischel: 'The Marshmallow Test: Mastering Self-Control", The Diane Rehm Show, NPR, October 1, 2014.

[2] Amazon.com, Inc. has returned 44% annualized over the five years ended April 30, 2018. Enron fell from a peak of $90 per share in August, 2000 to less than $1 in late November, 2001. WorldCom peaked above $60 in the late 1990s, and went bankrupt in 2002. Sources: Morningstar, Wikipedia, Marketwatch.com.

[3] "How Emotion Shapes Decision Making, The Intentional Workplace, March 15, 2012.

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