
BOOK REVIEW



Mark Kritzman, Senior Editor

THE BEHAVIOR GAP— SIMPLE WAYS TO STOP DOING DUMB THINGS WITH MONEY

*By Carl Richards,
Portfolio/Penguin, 2012,
Hardcover
(Reviewed by Javier Estrada,
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Readers of the ‘Bucks’ blog in the New York Times are obviously familiar with Carl Richards’ weekly columns on personal finance. Richards’ back-of-the-napkin drawings illustrate, and nicely complement, his simple but insightful articles on basic issues relevant to individual investors. Now, finally, Richards has put his thoughts (and illustrations!) together in a short, easy-to-read, and instructive book called *The Behavior Gap*.

If the title does not suggest much about the book’s content, fear not; Richards explains its meaning in the first chapter. Interestingly, the behavior gap is a term coined by Richards himself to label the gap between *investor* return and *investment* return. This is a critical issue that technically refers to the difference between dollar-weighted return and geometric return, the former being the investor return and the latter the investment return. And the evidence here is overwhelming: Investment return is almost always larger than investor return.

How come? Very simple. What this fact essentially shows is that investors are terrible market timers. They tend to buy high and sell low, thus obtaining lower returns than those delivered by the products in which they invest. For years Morningstar has been calculating, for

the universe of funds it covers, both the return of each fund and that of investors in the fund. Unsurprisingly, the former is virtually always larger than the latter.

Just to drive this very important point home, let me remind you of one more interesting fact on this issue: Although Peter Lynch delivered annualized returns of 29% during his 13 years at the helm of the Fidelity Magellan fund, *half* of the investors in the fund during Lynch’s tenure *lost* money. So much for investors’ ability to time the market!

Richards puts the distinction between investor return and investment return, and the corresponding behavior gap, at the heart of his message to individual investors. In fact, Richards’ recommendations are solidly based on modern financial theory: Diversify widely,

minimize costs, avoid chasing fads, avoid trying to time the market, prevent your instincts from determining your investment decisions, rebalance periodically,... you get the picture. All basic but important advice, which many investors do ignore to their own detriment.

The book's ten chapters cover a fairly wide ground. Richards takes time to discuss investors' psychology, the futility of forecasting, what investors can and cannot control, the importance of planning and sticking to plans, the entertainment (but not investment!) value of TV commentators, why gurus should be ignored, and a wide variety of issues too long to mention here.

Richards cleverly emphasizes the many psychological aspects that play against investors and the returns they obtain. To

illustrate, he discusses overconfidence and how it increases the cost of investors' mistakes. He also discusses the dangers of following the crowd, advising investors to base their decisions on what they need to do to reach their goals instead. And siding with value investors (but not with the prevailing view in academia), Richards argues that because of investors' tendency to follow the crowd, the "more expensive stocks... are, the more risky they are—yet that's when we tend to find them most attractive." Psychology again.

I cannot help to make at least a passing reference to some of the napkins (illustrations), though obviously these are better seen than discussed. Needless to say, there is one depicting investment returns, investor returns, and the behavior gap. Another

depicts cycles with 'greed/buy' at the top, 'fear/sell' at the bottom and the inscription 'repeat until broke!' Another shows two intersecting circles, one that reads 'doing something dumb,' another that reads 'hoping someone else is dumber,' and the intersection labeled 'the greater fool theory.' And one of my favorites, another two intersecting circles, one that reads 'things that matter,' another that reads 'things you can control,' and the intersection labeled 'what you should focus on.'

In short, although sophisticated investors may not find groundbreaking insights in Richards' book, I believe most individual investors will benefit from reading it. It is short, easy to read, common sense and sensible financial advice,... and yes, it does have fantastic illustrations!