Dr. Patrick O'Brien's

May 2022 Client Note

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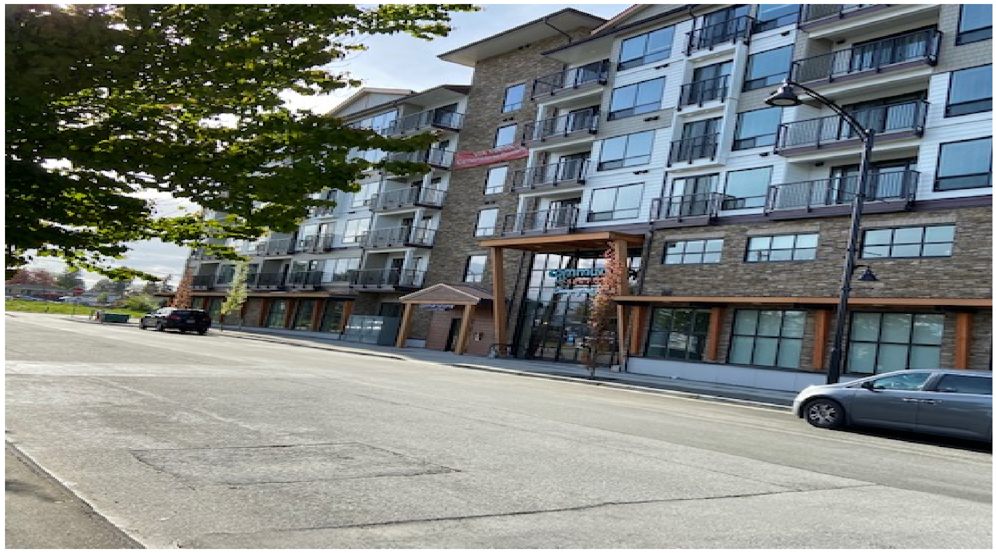

Human Brain Function and Risk Perception

Pretend with me now, as I have created a hypothetical situation down below where we are real estate tycoons ☺

Consider the building in the photo and assume that we bought it for $20 million in 2019. The building is well made and the maintenance has been kept up to date, the taxes are paid, and the tenants are content and paying their rent. In short, all is well.

You and I have noticed that the assessed value has increased rapidly in a 3 year period – from $20 to $30 million. Last summer at the peak of a real estate boom, a realtor contacted us with a proposal for $35 million. We turned it down because we bought the property for income today and moderate growth over the long haul.

But just last week, the realtor returned with a proposal offering only $27 million. Why you ask? Interest rates and inflation are up, there is a war in Europe, and the bank will only loan money based on the lower purchase price was the reply.

Well, we weren't willing to sell at $35 million, because the investment was providing an income as expected, so why, with nothing on the ground changed, would we sell it now for less than the last (rejected) offer? Easy-peasy right?

It is relatively easy to dismiss this radically lower offer and carry on with daily life as before – "no muss no fuss" as they say. It is far more challenging to stay relaxed when markets turn down and a portfolio loses value. But why? The portfolios we have are much more diversified across human needs, sectors, geography, and have a higher/rising income that is taxed at a lower rate. Most portfolio companies send monthly bills to customers. How many people are going to ignore their cell phone bill this month because the price of gas is up? What about electricity or heating bills? I suspect that the bills will be paid this month, next month, and into the future. This perceptual difference of risk between the building and the portfolio makes no sense – unless you consider the design of the human brain and how the safety of the building versus the portfolio is perceived.

Very simplistically, we have the equivalent of two anatomically and functionally distinct brains. The "emotional" brain is designed to protect us from immediate harm when it perceives danger from our sensory inputs (sight and hearing principally). The second "thinking" brain is a reasoning brain. I am using it right now to write this article. This brain works very well when the problem is not immediately life threatening. We must use the thinking brain to be effective in our financial lives. We don't seem to have any trouble using the thinking brain when considering the reduced offer on the building, but it is much more difficult to stay firmly in the thinking brain when considering our investment portfolios. So, keeping in touch with my inner 4 year old, I ask again, "Why the difference?"

We are heavily influenced by media hyperbole. The perception of a down trending stock market is that we are in serious danger so the emotional brain kicks into high gear and over rules alternative perspectives from the thinking brain for a period of time. It takes practice, experience, reflection, and sometimes a conversation with me to calm the emotional brain and allow the thinking brain to reassert itself. I am here for you – please do not hesitate to reach out.

Here's to some warmer weather so the bees can do their part!

Best Regards,

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