CHAPTER 1

# Motivation

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> Know why you are doing a trade before you trade.

## Why Are You Trading?

David, a well-to-do dentist, is settling into his home office on a Friday morning. He usually takes Fridays off from work. In the morning, he likes to trade stocks and in the afternoon he plays golf. David has CNBC on the TV in the corner as he settles in to read the *Wall Street Journal* and FT Alphaville. He mostly likes to bet on quarterly corporate earnings announcements, usually by trading short-dated options.

David's wife, Rachel, comes into the home office:

Rachel: "Going to pick up some things at the supermarket. Want anything? How are things going by the way?"
David: "Good, earnings season is heating up. Got a good feeling about some of these picks I've made."
Rachel: "How have you been doing so far this earnings season?"
David: "I made a couple of good calls yesterday. Decent. Nothing like that awesome streak from last year, but pretty good."
Rachel: "So you're making money?"
David: "Look, there's a lot of variance so it's hard to say for sure. What I do know is that when I get in the zone, like I did those couple of weeks a year ago, I make all the correct calls. It's like Neo from the Matrix."

Rachel: "Neo traded options?"
David: "No he didn't. But when he got in the groove, time slowed down and he couldn't miss. That's how it feels when you're trading and you're feeling it. Like you almost can't lose."
Rachel: "Can't lose? I thought there was a lot of variance."
David: "Ah, you just don't get trading … "

### *Shouldn't This Chapter Be Short?*

If people were perfectly rational, profit-maximizing, highly capitalized[1] entities, this chapter would be quite short. "Why are you trading?" *To make money*. But the real world is more complicated.

Even if we were perfectly rational profit maximizers, there would still be very good reasons to trade other than "to make money." For example, when you buy home insurance you know (and in fact hope) that the expected value[2] of that transaction is negative. However, you buy the insurance anyway because it decreases the risk of a huge loss if your home ever goes up in flames. You are said to be *hedging* your home-loss risk, and it's perfectly rational to do so. When we cover this idea in detail in Chapter 3, you will learn that the quantity you want to maximize is not profit but *utility*, a sort of risk-adjusted notion of wealth. So, are people who trade in financial markets motivated by utility?

In a trivial sense, anyone can answer yes after the fact. Much like a child who trips and falls and says, "I meant to do that," utility is what we claim it is. But humans are complicated, and *perceived* utility comes in many forms that differ from *actual* utility. In fact, as described in great detail in various recent works (especially Daniel Kahneman's *Thinking Fast and Slow*), humans are an unreconstructed bag of cognitive biases that cloud our judgment of utility. There is a whole field of social science called behavioral economics that seeks to identify and understand all the ways in which we fail to behave as perfectly rational decision makers. And it turns out that by and large we humans are quite poor decision makers:

- We underestimate small probabilities sometimes (the chance of getting hung up in traffic and arriving late to an appointment) and overestimate them other times (the chance of dying in a plane crash).

- We consistently overestimate our knowledge (a cognitive blind spot known as the Dunning-Kruger effect) and abilities (well over half of surveyed people think they're better-than-average drivers).
- When suitably framed, we consistently say that A *and* B occurring is somehow more likely than A only occurring. When we do this, we're violating a basic principle of logic without even noticing it.[3]

Many of our motivations, our sources of utility, aren't even *about* profit or risk-adjusted profit. This is obviously true in general, but it's even true within the narrower world of trading. We really do need to examine these trading motivations in detail, since they surface most clearly in the world of financial markets but they can also appear in other trading-like contexts. This fact alone should make the following classification of human foibles useful even if you've never dabbled in financial markets. Let's take a tour of the irrationality that characterizes the human mind and the sometimes-odd places it finds utility.

### *Greed and Fear*

Greed and fear are the famous emotions of trading, and of financial markets in general. Recall Gordon Gecko in the movie *Wall Street*, or the Duke brothers in *Trading Places*, and how they were motivated by greed and fear. Many books have been written about these emotions, and how they relate to trading: how to mitigate their effects, how to use these emotions positively, how the induced herd-like behaviors affect the markets themselves, and many other aspects. There are books and articles that purport to teach amateurs how to "think like a pro" with respect to these subjects, and hence trade profitably. Without casting aspersions on specific works, almost all of these books are worse than worthless: they focus you on the *wrong thing*.

The plain fact is that almost no professional traders think of their work in terms of greed and fear. The profitable trades they've developed, the systems they've built to trade them, and the social environment in which they work are all designed to make these emotions fade into the background. In a highly underappreciated paper from over a decade ago (Lo, Repin, & Steenbarger, 2005), the

authors study a population of traders, and correlate their results to their emotional states and personality types. The results show clearly that the traders whose emotional reactions were the most intense were the least-successful ones. It didn't matter whether the emotions were positive or negative, it was the fact that these emotions weren't being modulated. Interestingly, the paper also shows that there was no apparent correlation between personality type and success at trading. Thus, the stereotype of the loud, hard-charging, aggressive trader is not borne out in the data. All personality types can be successful, in principle.

Other studies of the emotional reactions to risk taking are found in *The Hour Between Dog and Wolf* (Coates, 2013). The story is similar: to the extent that trading and risk taking cause emotional reactions, those reactions generally obscure clear thinking in those high-pressure situations. This is not to say, however, that there is no place for emotion in trading. It's that the specific emotional reactions need to be trained, just like every other aspect of your approach, and greed and fear just aren't terribly useful.

> In my own case, I know that I tend more toward the fear end of the spectrum. When I was first starting out in trading, I didn't have any real trading authority. I did what senior traders told me to do, learning as I went. But eventually, I got the opportunity to make my first real trading decisions. That first time I decided to buy those upside call options in Deutsche Bank, I knew intellectually that it was a good decision. But that didn't entirely inoculate me from the fear that I had either misjudged the situation or that the trade would go against me by random luck. There isn't much you can do about that latter situation, but tell that to your amygdala (the grey matter inside your head that experiences emotions) while it's happening. Over time, as I got feedback and validation that I was making good decisions, I managed to retrain my emotional reactions into more useful forms.

### *Boredom*

Greed and fear are, in the world of trading, two extremes of the same emotional continuum. They are emotions related to high activity: winning or losing. Something's happening. But along another

axis, we know that the level of activity in financial markets varies greatly. And most of the time, in modern financial markets, not much of anything is happening.

Quick, go Google "trading boredom." If your results are anything like mine, the top few results will be articles on amateur trading blogs and websites that try to give people tips on avoiding boredom. Evidently, this is a common problem among amateur traders, as well it should be. People frequently claim they're getting into trading because they want to make money, but in fact the reason is much closer to: "it gives me something to do," like our friend David at the beginning of the chapter. And often, there really isn't anything to do. The average amateur trader, no matter how prepared or sharp, is not going to find very many obviously profitable trades to do (assuming they're not fooling themselves). The result is long stretches of doing nothing, which is certainly not what they signed up for. The prevalence of articles trying to help amateur traders "deal with boredom" is all the evidence we need that many people indeed get into trading to avoid boredom.

Boredom is probably what brought David to trading in the first place. Trading certainly gave him something to do on those free Fridays, and he sunk his teeth into it. He read reports, created spreadsheets, looked at historical data, and slowly built up an earnings-based options-trading strategy. The problem was, most of the time the data told him to do nothing. Edge—your technical or strategy advantage over others in the trading arena–is hard to find, after all. The boredom returned, and so David started dabbling in other sorts of trading. He wanted a feeling that comes with putting money in play. That feeling is frequently known as the Zone.

### *The Zone*

In the excellent book *Addiction by Design* (Schüll, 2012), Natasha Schüll takes the reader into the world of video poker and slot machines. She describes the manner in which these machines are designed to take advantage of the predilections and desires of problem gamblers. This subpopulation is targeted specifically because compulsive gamblers are by far the most profitable segment of the gambling public.

Particularly interesting is her description of the exact value that is the utility that problem gamblers derive from these machines,

especially considering the often significant personal cost of their addictions. She describes in minute detail the fact that these problem gamblers aren't necessarily seeking wins, exactly. What they're looking for is a feeling, a sensation of transcendence that playing these slot machines provides. The most common name for this feeling, one where time itself seems to melt away, is "the zone." Consider Katrina, on page 135 of the book:

> *The best scenario is when the free spins have been coming around regularly and perhaps normal game play has been good as well. … This is where it particularly feeds into the zone where you can play for quite some time. … You can just relax and "lose" yourself.*

There are many other similar reports in the book. This zone that ensnares problem gamblers can also appeal to traders, especially active day traders. When caught in the zone, the goal of active trading isn't to make money. Rather the motivation is the process itself of making decisions and living in the world of price movements and charts, escaping normal life. Of course, many books and marketers exploit this desire to enter the zone. Consider the highly popular book *Trading in the Zone* (Douglas, 2000). The following passage from the preface is particularly telling:

> *While this may sound complicated, it all boils down to learning to believe that: (1) you don't need to know what's going to happen next to make money; (2) anything can happen; and (3) every moment is unique, meaning every edge and outcome is truly a unique experience. The trade either works or it doesn't. In any case, you wait for the next edge to appear and go through the process again and again.*

Couldn't such a paragraph have just as easily been written about "successful" slot machine play? It's clear that the focus is not at all on making money, but rather on getting the feeling of making decisions and then ignoring the results. What's important for our friend David at the beginning of the chapter is entering the zone of day trading. Profits really are secondary.

### *Risk Seeking*

We live in an uncertain world. Whether it's winning the lottery or having a tornado flatten one's house, uncertainty rules our lives. Even

everyday activities carry uncertainty: will I get a ticket if I park in the fire lane for five minutes? Will I meet the woman of my dreams if I stay in the library an hour longer?

You can think of every single action we take as a decision made to shape an uncertain future. So how do you make these hundreds of decisions a day? Do you carefully weigh all the costs, benefits, and risks[4]? Of course not. Most of the time, you make largely automatic decisions because if you didn't, you'd be paralyzed by this careful weighing process. Behavioral economists call this automatic decision-making process "System 1" and the more deliberative process "System 2." What concerns us in this section is how our System 1 works, and how it automatically assesses risks and rewards. It turns out that we all carry deep within us a surprisingly well-defined taste or preference for risk, which we'll call our risk-tolerance setpoint.

In a study by John Grable and Abed Rabbani of the University of Georgia (Grable, 2014), the authors examine the question of whether risk tolerance is a broad-based disposition, robust across many domains, or whether it's domain specific. Using a large panel dataset from the National Longitudinal Survey of Youth in 2010, they discovered that indeed people's risk-tolerance is quite robust across domains. A single "risk-tolerance" factor explains the majority of variation for a variety of behaviors, from everyday risky situations such as smoking to financial and occupational decision-making.

So, if indeed you have a well-defined risk-tolerance setpoint, an interesting question presents itself: what if the life you lead has a dramatically different risk profile than the one with which you're comfortable? What happens to you, and to your decisions?

Taking a page from biology, we can theorize a sort of risk homeostasis process. If Janine's life has more risk than she'd like, then she'll avoid additional risky situations in order to seek stability and certainty, even if those situations are advantageous. If Leroy's circumstances are overly stable and riskless, we should expect him to seek out risky situations in order to get closer to his natural risk-tolerance setpoint. My own risk setpoint was exposed when I started trading. Before my career as a trader, back when I was an engineer, I played a lot of online poker. I was good at it, and it evidently filled a need for some randomness in my otherwise stable life. Almost to the day that I started my job as a trader, my desire to play cards for money evaporated. My regular job had plenty of randomness for me, and

I certainly didn't need any more. I had found my risk setpoint in a different manner.

You may argue that's just me, but the best screenwriters in Hollywood certainly believe in risk setpoints. Classic caper movies, such as *Ocean's Eleven* and *The Italian Job,* start with the lead character having just been released from prison. Free from their incredibly boring prison existences, Danny Ocean and Charlie Croker, respectively, immediately set about plotting their next heist. Far from setting them on the straight and narrow, their prison experiences push them strongly back in the direction of action, of getting closer to their risk-tolerance setpoints. The reason you believe in these characters and that you empathize with them (aside from their matinee good looks) is that you instinctively understand that the high-risk lifestyle is fundamental to who they are.

You may now argue that that's fiction. But real life provides plenty of similar examples. In the documentary film *Free Solo*, for example, we follow Alex Honnold as he attempts to scale the 3000-foot-tall granite wall known as El Capitan in Yosemite National Park, California. Rock climbing is already risky enough that most life insurance policies consider it a disqualifying factor. But Honnold goes a giant step further: he scales these massive walls with no ropes or other aids. One wrong move and he would inevitably fall to his death, as many of his fellow free solo climbers have done. What rational person could bring themselves to take such extreme risks? The film provides us some answers: an MRI scan of Honnold's brain shows no activation in his amygdala, the fear center. Honnold is, to all appearances, virtually incapable of feeling the sort of fear that would make our System 1 scream to stop a risky activity like free soloing El Capitan. Yet Honnold has no death wish. He states, believably, that he'd much rather avoid dying. It's just that the only times he feels alive enough to be worthy of the term is when he's taking life-threatening risks. You can't argue with your setpoint.

This fact is not lost on the various financial intermediaries we learned about in the introduction. The financial services industry, at least at the retail level, clearly markets itself to affluent people with exactly the sort of language that will appeal to people motivated to seek financial risks. Our friend David at the beginning of the chapter, comfortable but somewhat bored in his comfortable life, is trying to increase the amount of uncertainty in it.

It should come as little surprise that trading in high-volatility stocks can be an excellent way of exposing yourself to financial risks. While the advertised and perceived goal of trading may be about finding good trades and making money, given what I've learned about risk-tolerance setpoints, it's just as likely to be about finding ways to put money in play, to expose yourself to profits and losses.

### *Wanting a Big Score*

We've established that different people's tolerance of risk varies and that it varies in consistent ways. But people's perceptions of the value of a trade vary in equally interesting ways. Consider lotteries. Why are lotteries as popular as they are? They pull in an exceedingly large amount of money, by some estimates as much as $70 billion per year (Thompson, 2015) in the US alone. What is it about their structure that makes them so incredibly attractive?

Consider a bet where you are asked to flip 8 fair coins. If they all come up heads, you win $255 and otherwise you lose $1. Would you take this bet? What about paying $1 up front to play the following game: flip 8 coins and if they all come up heads, you win $256.

If you're like most adults in modern Western society, the second game *sounds* more attractive than the first, in spite of the fact that they're identical in every respect except the wording of the game. By changing the description of a bet, I can change your intuitive (or heuristic, System 1) perceptions of its attractiveness. Behavioral economists have, over the last 30 years, studied in great detail the ways in which the wording of uncertain outcomes affects perceptions. But again, the manner in which the financial industry markets itself to retail consumers shows they understand these effects quite well too.

In the above two examples, you can calculate that your expected profit in the games is zero. Your losses in the majority of cases (when at least one tail comes up) exactly counteract the very rare win when all heads come up so that on average you make no money playing this game. But if I can formulate the game so that the big rare win is more mentally salient than the small costs incurred to play, I will get many people interested in playing the game. And if I can increase the cost to play by a small amount (say $1.10), then I've created a game that's actually profitable for me, the seller of the game, as well as attractive (though a losing proposition) to the buyer.

Lotteries are so successful at hacking the human brain's risk perceptions that governments typically claim a monopoly on the right to run them! But financial products with highly asymmetric payoffs like those of lotteries also exist. The most common of these, at least in the US, are options, especially out-of-the-money options. These products have the payoff of small lottery tickets: they cost relatively little, most of the time they expire worthless, but every so often they win. When they do, the payoff can sometimes be a multiple of their original purchase price. For example, let's say Amazon is trading at $2,000. Earnings are coming up, and you bet that they're going to be bad. So, you purchase a $1,800 strike put (the right to sell), for around $16. Most of the time, Amazon will not drop below $1,800 upon earnings, and the put will expire worthless. But if Amazon drops to $1,700, then you've made a profit of $100 – $16 = $84! It's perhaps no surprise that deep out of the money options (such as the above) are consistently more expensive than their historical probabilities would indicate they should be.

All of these products prey on the buyer's desire for a large payoff without exposing herself to a large loss. By hiding the probabilities of the various outcomes, and by emphasizing the rare win, you are induced to lose a small amount of money. Aggregated across millions of people and repeat buys, this can be a very profitable business for the seller. As the old poker saying goes: *You can shear a sheep many times, but you can skin it only once.*

### *Intellectual Validation*

Financial markets are some of the most competitive environments on Earth. What's more, the winners and losers are determined with piercing clarity: whoever made the money won the contest. Couple these characteristics with the already mentioned low barrier to entry, and one should expect a large number of aspirants to the throne of King of Trading.

In the same way that competitive sports appeal to the more athletic among us, trading appeals to the intellectually competitive. Being able to win at trading implies, in the popular imagination, having a sharp mind, good instincts, and a strong desire to win. The world of trading provides a compelling arena in which to test one's wits.

In fact, even a quick perusal of academic literature shows all manner of scientists, mathematicians, economists, and psychologists writing papers purporting to show how to beat some market or other. Invariably, the theories and techniques of the source discipline are applied to financial markets, and attempts are made to show those techniques can be used to make money trading. In the great majority of cases, these papers exhibit fatal flaws, ones which means they do not contain actual profitable trading strategies. From a distance, this should come as no surprise: if some obscure technique known only to a few algebraic geometers were capable of producing a trading profit, why would these geometers give it away to the world in exchange for a mere citation count?

Using trading as a means of intellectual validation isn't restricted to academics, of course. In the same way that poker players find stimulation from playing games above their bankroll and skill level, people who do not have the capital, skills, or information to compete in financial markets try to do so anyway. Their primary motivation is not to make money, but rather to test themselves. If they make money then that means they've successfully tested themselves, but in any case, the former is a secondary consideration compared to the latter.

> If I'm being perfectly honest, intellectual validation motivates me more than I'd like to admit. I enjoy reading mathematics and machine learning papers, and I enjoy thinking about ways to apply these ideas to trading. I'd tell myself that this was an important part of my job, and it was. But a lot of the motivation, perhaps too much of it, was finding a cool mathematical technique to apply to financial markets. It was about the math, not the trade.

## Why Does Motivation Matter?

You may have noticed that a common thread runs through the above list. By and large, these motivations privilege a feeling or emotion, and the goal of trading becomes obtaining or satisfying that feeling. We can't say categorically that people are wrong for

having these motivations. But, to the extent that they are unaware that the true reason for our trading *isn't* to maximize profit, they're setting themselves up to be exploited by others who (a) do care about maximizing profit, and (b) know them better than they know themselves. Self-knowledge, Aristotle tells us, is the most important kind of knowledge.

As you've already seen, the world is full of people with varying degrees of scruples about exploiting human frailty for profit. By being aware of your own weak spots, you can more easily navigate these dangerous waters. Let's now restate the rule at the beginning of this chapter.

*Know why you are doing a trade before you trade.*

You can now see why such an obvious-seeming rule can be so difficult to follow. As you've seen, "knowing why" can be fraught with danger and self-deception because of who "you" is. Thus, the first way in which we should think about the rule is less as a rule about trading and more as a rule about self-awareness. Does David the dentist really understand enough about himself to realize that, deep down, his trading isn't about maximizing profit?

## Make Peace with Your Motivations, or Change Them

Let's say you've done a careful mental and emotional inventory and find that much of your motivation for trading in financial markets comes not from a profit motive, but from something else. Typically, this something else is a desire to achieve or change a particular feeling or emotional state. What do you do then?

Certainly, the least difficult avenue is to simply proceed as if nothing had changed. There is no rule that says that the trades you do must be made for financial gain. Maybe you're trading because it's fun, and the losses (in expected value) that you suffer are payment for your entertainment. If this is the case, I hope to convince you there are cheaper and more effective ways to get those results. Besides, no one ever said you *had* to do unprofitable trades in order to get your entertainment!

If you're like many successful traders, accepting this state of affairs is intolerable. You feel you're being exploited by the clever marketing strategies of financial services firms large and small. You feel you're being duped into believing you're making good trading decisions while all the time they're the ones making the money! For

you, the rest of this chapter will serve as a guide to structuring your trading in order to avoid the pitfalls of unknown or nonconscious motivations. It will also show you the way to maximize the value of following our rule.

## The Role of "You"

### *Protecting Ourselves*

If you do want to avoid the sort of hazards triggered by your unawareness of the nature of motivation as described above, how do you go about it? You might be tempted to think that, if the most common ways of going astray revolve around your feelings and emotions, then you must surely strive to eliminate them. Call it Star Trek-itis, an inflammation of the desire to become Spock or Data. Unfortunately, for humans this is much easier said than done. Not only that, but emotions can be a useful guide in trading. Therefore, as you'll soon see, ignoring them can be just as dangerous as falling under their spell.

So what is to be done? We can find a path forward by seeing that the problem with the motivations we examined wasn't that they were informed by feeling and emotion, but rather that those emotional states were end goals in themselves. In a very important sense, trading isn't *about* feelings, even if those feelings can be useful in trading. A pithier way of stating this is: *trading isn't about you.*

That being the case, the question remains: what is trading about? Fundamentally, it's about the relationship between you and the rest of the world. Trading to maximize profitability isn't about you, fundamentally. It's about finding and exploiting a profitable edge, and as we will see in Chapter 5, these edges come from things that specifically and in particular you know and can act upon *that others cannot.* The only "you" that matters is how you relate to the others against whom you're competing. The best protection against bad motivations comes from an honest assessment about the nature of your edge, and this requires deep self-knowledge but also, critically, deep knowledge about the markets in which you're trading.

### *Making "You" Small*

In 2009, the computer scientist and entrepreneur Paul Graham wrote an insightful short note entitled *Keep Your Identity Small*

(Graham, 2009). In it, he theorizes that the reason discussions about religion or politics quickly become useless is because these areas deal directly with notions of personal identity. In subjects where self-identification and self-labeling become important, we lose the ability to think rationally about the matter at hand. We become preoccupied with protecting and justifying "me" and the discussion stops being a productive one. While his analysis centers on the difficulty of having useful discussions about religion or politics, the point made about the dangers of an expansive notion of "me" has much broader applicability.

In the context of trading, having a large self-image (in the sense of maintaining many labels to describe yourself) creates similar difficulties for rational decision-making. The more statements of the form "I am the kind of person who … " you feel you must satisfy, the more ways the market and its participants can attack you and get your money.

### *Caring about the Right Things*

So how do you make your self-image small? How do you make yourself care about the right things? You could, through sheer force of will, change your motivations. However, evidence from many experiments shows this is extremely unlikely to work over the long term. Our willpower is a finite quantity that is difficult to maintain over time. Fortunately, researchers have discovered at least one way to make long-term changes in our behavior: the mechanism of precommitment (Crockett, 2013). Precommitment and habit have been extensively studied in the social sciences, and these techniques have been shown to be capable of effecting significant changes in behavior.

In his book *The Power of Habit* (Duhigg, 2012), Charles Duhigg shows the ways in which we can change our behavior by precommitting and forming a habit that forces the desired behavior to emerge. For example, suppose you want to stop raiding the cookie jar for a midafternoon snack. You need to create a habit that prevents or forestalls such an act. You could, perhaps, set an alarm for a time slightly before your usual trip to the kitchen, and when the alarm sounds you eat a banana you've already set out beside your desk. By creating a new desirable habit to replace the old undesirable

one, you've changed your behavior without having to rely on willpower alone.

So how does this apply to trading? The idea is to create structural habits that strongly encourage good decision-making processes during trading. This means establishing an intellectual culture that fosters the right sort of mindset about trading. I will have much to say about this in Chapters 5, 9, and 11, but for now we can simply say that the crux of it is sociology.

Having a set of people with whom you can talk about your trading ideas, creating a systematic process for evaluating them, making plans, and evaluating those plans, all of these are ideas that are fundamentally social and cultural. If you're successful in creating such a culture, the desirable habits become automatic and the day-to-day decision-making inherent in trading becomes the sort of process you want.

## Precommitment and Hindsight

Why does the rule tell us you should have your reasons sorted out before you do a trade? If you can retrospectively show that your decision was a good one, surely that's good enough?

Given what we now know about the human mind, it should be obvious that it's not. Hindsight bias is among the most significant and hard-to-eliminate biases to which we're subject. Also known as the knew-it-all-along symptom, hindsight bias makes you believe that, after something has occurred, you could have predicted it or did in fact predict it. Indeed, you get this clear impression quite frequently, despite your having no reasonable basis for making one prediction or another.

The most powerful protection against hindsight bias is, perhaps not coincidentally, precommitment. If you explicitly record your beliefs before an event occurs (in this case, a trade), you have made it more difficult to backfill a convenient story after the fact. This record doesn't have to be particularly strong in order for it to help protect you against hindsight bias. A simple note jotted down on a piece of paper, a statement to a colleague about your thought process, all of these serve in your brain as markers of beliefs *at the time*. The rule tells you to take advantage of this, to actually use it to your advantage. Again, one of the best ways to avoid fooling yourself

about your previous beliefs and motivations is to set them down in writing at that time. After all, it's hard to argue with a piece of paper.

The most powerful way to leverage precommitment is to make it structural. Structural precommitment is culture. It's a habit of writing things down, of making conditional plans and decision trees to describe your future actions. It's precommitment that's so ingrained it becomes the default action. This habit can be personal, but it can also be encoded in the culture of an organization. This is what lets you analyze your thought processes in a less-biased manner, and to improve them over time.

## Self-Knowledge and Precommitment in Other Contexts

We can extend the insights of the rule about trading into many other contexts where we need to make rational decisions.

### *Buying a New Car*

Aside from buying a house, few purchasing decisions are as nerve-wracking as that of buying a new car. You could in fact argue that buying a car is more stressful. After all, each house is unique so it's harder to conclusively establish whether you underpaid or overpaid for the house. However, cars are (ideally) undifferentiated from each other. If someone else paid less for the same car, they clearly got a better deal. Dealerships remain, in spite of some progress, places that are structured to extract as much from the consumer as possible. Even internet sales divisions aren't immune to these characteristics. So how can you use the rule to help you?

- *Self-knowledge*: How motivated are you to buy on that day? How much time do you have, how patient can you be? Could you change your mind about details of the car? How do you want to approach the conversation with the dealer? Is your inclination to be friendly, or to be adversarial? You should think about these and many other questions before you enter the dealership. Dealers are trained to understand these tendencies and to exploit them to their advantage.
- *Precommitment*: How knowledgeable are you about the buying process? In fact, most car purchases can be regarded as

about a dozen possible purchases: the car itself, after-market accessories, extended warranties, service plans, rustproofing, paint treatment, insurance, and just about anything else related to the car. Have you already studied these items and made decisions about which ones you want? With this knowledge, you can precommit to buying only the things you actually do want, instead of having to make a decision at the time. Write down the decisions you've made and bring that paper to the dealership. When in doubt, refer to the paper!

### *Navigating the Job Market*

Looking for a job and accepting possible offers is fraught with peril, and having good self-knowledge is the first step in making good decisions about the jobs you seek and accept. The most important piece of self-knowledge you need, unsurprisingly, concerns your own motivations: what is it that you look for in a rewarding job? Is it money? Prestige? A good work environment? Interesting work? Many people can endure a bad job for good pay, but others feel that an interesting job with good co-workers is non-negotiable, even if the pay isn't as good.

It's at least a little surprising that, given the importance nearly all of us attach to our job, there is so little practical and tailored help available to help you when shaping and planning your careers. Yes, high schools and universities do have career guidance programs, but given the ratio of supply to demand, in practice they generally provide little value. Fortunately, a good (and humorous) guide can be found at the Wait But Why website (Urban, 2018). Though quite long, the guide takes you through the process of truly understanding yourself and your motivations, especially as they relate to jobs and careers (I encourage you to have a look).

Once you are in the process of finding a job and accepting offers, self-knowledge continues to be important, but perhaps just as important is a small dose of precommitment. Suppose you know that, in order to be happy and satisfied, you will require a certain minimum salary and, perhaps, a minimal level of status or seniority. You then ask yourself what you would do if you received the job offer but it didn't contain those minima. What are you going to do? You might

be sorely tempted to accept the offer anyway, under the "a bird in the hand is worth two in the bush" philosophy. Yet if you know that the absence of those non-negotiables will lead, over the longer term, to unhappiness and disappointment, perhaps the right thing is to hold out for them. You can precommit yourself: if the offer doesn't have certain must-have characteristics, you will decline (or negotiate to obtain them).

The same precommitment process is important during the job search itself. If you know yourself well enough to understand that having a good personal rapport with your boss is important to you, you can precommit yourself to that. If a job offer comes in with good salary and other benefits, but you know you won't be able to get along with your boss, then the right answer is to decline. Precommitment helps you clarify your understanding of yourself and clarify your priorities. This leads to better decisions over the long term.

### *Precommitment for Self-Improvement*

Sometimes precommitment can seem like a magic wand to get us more of what we want, and other times it can make us miserable and yet not get the results desired. How can you tell which of the two you'll get in some specific situation?

Consider the website stickk.com. The idea behind the site is that you register your goals with the site (for example, to lose weight or to finish writing a book). You commit that if you fail to meet your goals, you'll accept a financial loss (such as giving $5 to charity, or to the campaign of a hated politician). Furthermore, your friends and relatives, or even strangers, will be notified of your failure to meet the goal. The question is: does this sort of precommitment work?

It seems the answer is "it depends." Specifically, it depends on how much you dislike the loss you'd incur compared to the difficulty of meeting your goal. If the stick isn't big enough, the rational thing to do is still to shirk our goal. However, making the stick big and painful enough may well just make your life miserable. You're forcing yourself to do something because of an external motivator, as opposed to an internal one. As you'll see later in the book, evidence shows that this can be useful for stretches of time, but over the long term, external motivators may actually be counterproductive. As with all things, precommitment is a tool to be used judiciously if it's to maintain its usefulness.

## Summary and Looking Ahead

- The most important knowledge is self-knowledge. Be aware of your tendencies, your flaws, your blind spots, as well as your strengths.
- Don't rely on your willpower to ensure you make good decisions. Create a structure that encourages the right sort of decision-making processes and they will become habitual.
- Precommit to courses of action that you want to take. Make the wrong path hard to walk.

In the next chapter, we'll actually dive into trading: what's it about, and how does it actually work? As we'll see, things can get pretty hairy pretty quickly, and it all has to do with information. Who has it, and how much of it do they have?

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