



Every take off is optional, every landing is mandatory (Or why math doesn't always align with real life) Part 2

Description

Real World Financial & Risk Planning Isn't Simple Math

All [financial planning](#) is a reflection of most common real-world planning problems. It's about the allocation of limited resources in the face of an uncertain future. Another term for this is [risk management](#).

Like all successful and sustainable systems or processes, proper financial planning is a result of dichotomous ideas merging together.

Financial planning is not about betting on the latest hot stock or believing that real estate is the best investment ever. Financial planning is about having a philosophical and practical framework from which to make financial planning decisions that have the highest likelihood of allowing you to achieve your goals. An essential part of that process is **prioritizing goals**, and understanding that the value of a dollar for one goal is not the same as it would be for another.

Further, one must recognize the [cognitive and other biases](#) that one has in relation to [money](#) and the various products related to it, so as to try and make decisions that are in one's best interest. A predetermined framework for this significantly simplifies the process and lessens the ambient noise or distraction when one is contemplating the purchase of a significant investment.

Financial planning is about having a philosophical and practical framework from which to make financial planning decisions

- The highest potential return is not always the best.
- The cheapest products often have the highest costs.
- Individuals do not act rationally; or put another way, people will not always act in their own best interest.
- Too much transparency effectively obfuscates relevant data.

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- Information asymmetry is the only rational advantage in a market situation equates to a lack of transparency greatly increasing the risks one takes.
 - As information availability in the marketplace becomes more symmetrical, the role of salespeople and advisors becomes one of cutting through the noise with curated data

It is easier to promise a higher return with a low failure rate than to sell the value of a guarantee. Even where the cost of the risk is catastrophic.

Let's consider what is a good price to sell risk at:

I have 100 stores. Money is collected from them 10 times per year. The average amount collected per store is \$500. So, the total amount collected annually is \$500,000. When transferring money from the stores to the bank, the money is stolen 20% of the time. An insurance policy is available that will reimburse all sums that may be stolen. What is the value of this policy?

$$\$500 \times 100 \times 10 \times 20\% = \$100,000$$

So if the cost of the insurance is less than \$100,000 it is a good deal. If the cost is more than \$100,000 the bet would have what mathematicians refer to as **negative expected value**. It would be a bad idea.

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However, there are times when selecting a proposition with a negative expected value may be the correct decision. Let's consider the above situation if instead of 100 stores and ten annual pickups (so the risk is being spread over a large number, 1,000, which should lead to a greater degree of convergence to the mean) what if all the risk were on a single event?

What if we were transferring \$500,000 all at once from just one store with a 20% chance of it being stolen?

The same math would apply purchasing insurance for less than \$100,000 would be a positive expected value decision and mathematically correct. Purchasing insurance for more than \$100,000 would be a negative expected value proposition and mathematically incorrect.

But if your entire year's income were on the line wouldn't it be worth paying more than \$100,000? With the scale of the loss to your organization wouldn't you consider paying \$125,000?

What if it were \$5,000,000 moved once every 10 years? Even if the odds of losing the shipment were only 20%, wouldn't a competent [risk manager](#) be willing to pay 25% or 30% (presuming the market wasn't offering anything better) to avoid the potential catastrophe of there being 0 income deposited in the bank for that decade?

On a personal note, consider making a really good bet. Imagine that the odds of you winning a bet were 200 to 1, and the layout was 1,000 to 1. But what if you could only place one bet? Would you bet \$1? Would you bet \$10? A \$1,000?

What if I told you the only way you could play would be to bet everything you had? Your house, car, pension, coin, and ugly sweater collections? Mathematically nothing has changed, has it? Same great odds but suddenly it doesn't seem to be as great a deal, does it? Yet financial professionals create [retirement plans](#) like this all the time. Life insurance salesmen allow similar situations by being too afraid or too ignorant to sell disability.

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2. Wealth Creation & Economic Confidence

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