OFG FINANCIAL FOCUS
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MENTAL ACCOUNTING AND THE ILLUSION OF "LOSS"

I was more than a little distressed, one recent morning, to see a financial new headline to the effect that Harold Hamm had lost twelve billion dollars.

You see , old Harold is kind of a hero of mine, He's one of those untutored geniuses that America throws up from time to time - an Edison, a Ford - who ends up revolutionizing the whole economic world. He was born the thirteenth and last child of Oklahoma sharecroppers in December 1945, and raised in an unpainted one-bedroom house that had no toilet. His highest level of education is a diploma from Enid High School.

Harold started out pumping gas, fixing cars and driving trucks - working his way up, hand over hand, in the oil patch. Until, in the fullness of time, he had his company, through painful trial and error, worked out a way to synthesize horizontal drilling with hydraulic fracturing and unlocked the vast reserves of the Bakken Shale. In the process, he became a billionaire as the value of his company soared.

(Sadly, Harold has gotten about a jillion times more press coverage in the last year from an epic divorce case involving his second wife than he ever did from his accomplishments. I'm no billionaire, but I could have advised him that there is a 100% guaranteed, foolproof way of never getting sued for divorce by his second wife. It is never to get divorced from your first wife. But I digress).

Anyway, it develops that in the recent halving of world oil prices, and the significant markdown of many oil company stocks - including that of Harold's Continental Resources - his net worth actually did decline by some twelve billion dollars. Please read that sentence again very carefully before we proceed further, because (a) the fact is undisputed, but (b) the verb used in the headlines reporting the fact is quite wildly offbase, in a way that may not be immediately obvious. And the difference between (a) and (b) is not semantic, but substantive. It has profound implications for all of us in the way we think about our investments, and especially in the way we react to changes in their prices over relatively short time horizons.

I say again: the fact that Harold's net worth declined by a factor of twelve billion dollars from its all-time peak is undisputed, It's a matter of public record. You just take his share ownership position in the company's stock, multiply that by the stock's peak price, subtract today's value for his stock, and you get twelve billion dollars, every single time.

But that isn't what the headline said, is it? It said he had **lost** twelve billion dollars. But that could only be the case if you accepted not one but two common mental fallacies, which end up being the undoing of far too many investors.

The first fallacy is that you measured Harold's experience of the stock only in terms of its decline from its peak price to wherever it is now, rather than measuring it from zero - where he started out - to its current worth. This is an emotional quirk - the folks in the white coats term it a *heuristic* -called ***mental accounting.***

Let's say that one day, in the full flush of the public's enthusiasm for shale stocks, Harold's shares had a market value of $24 billion (I neither know nor care what the exact number was, and it is perfectly irrelevant to the point I'm making.) We have observed that their market value subsequently declined by twelve billion, and this - I say thrice - is undisputed.

You can conclude that he **"lost"** twelve billion only by that peculiar twist of pretzel logic called mental accounting. But I would maintain (and I'll bet almost anything that old Harold would agree, though maybe not out loud in front of the divorce judge) that he has so far been enriched to the tune of twelve billion - from zero to twelve billion his recently depreciated shares are still worth.

And wait; I'm just getting warmed up. Here comes the second mental lapse: the idea that the gleefully headlined twelve billion dollar decline is **"lost"** to Harold. In point of fact, ***he hasn't permanently lost anything, because he hasn't sold his shares.*** He has most certainly experienced a whopping decrease in the market price of those shares, But he's still got them, and his company still has its reserves of oil and gas in the ground.

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The decline may continue for a spell; it may not. My blissfully unscientific guess, as a nearly fifthy-year observer of the commodity cycle, is that so much exploration, development and production of energy is being shelved at $50 a barrel (leading to less supply) and so much more consumption is being unleashed at the lower price (leading to more demand) that energy prices may eventually start cycling up again, and with them, potentially, Harold's net worth. At least that's the way it's always worked in the past.

I remind you that on the single worst day in the entire history of he American stock market - October 19, 1987 - Warren Buffett was universally reported to have **"lost"** $347 million. He didn't sell either, and at last report was worth about $44 billion. There's a critical difference between temporary decline and permanent loss. The former comes and goes, but in a well diversified equity portfolio, history suggests that the latter can be locked in only if and when you sell.

I'm inclined to the belief that a whole lot of people who, and I quote, "lost money in the stock market" in the last decade managed to do so only by succumbing to not one but both of these mental quirks. Especially in the Great Panic of 2008-2009, they characterized the experience they were having as a "loss" from the all-time market peak (up to that time) in October 2007. So that by the time the market troughed in March 2009 they saw themselves, *regardless of what their investments had originally cost them, as having "lost" over half their portfolio's value.*

The resultant emotions thereupon triggered the second mistake: they turned what was only a temporary decline into a permanent loss the only way the diversified investor has ever been able to do so in the past: by selling in a panic.

Know what your financial advisor is really for? ***To help you not think that way.*** He or she is not there to forecast the economy, nor to time the market, nor to handicap which mutual fund raindrop will get to the bottom of the window before the other similar raindrops. But simply to keep you from making the big mistakes that seem always to proceed from the big mental/ emotional lapses.

And one fine day, you may decide that your advisor's ability to do that made all the difference. In the meantime , don't be too concerned about old Harold, I expect he'll be fine. I just hope he doesn't go getting again real soon.

Everything we have is really loaned to us; we can't take anything with us when we depart. If we have no use for a thing, we should pass it on to someone else who can use it - now.

Norma S. Scholl

TO MY GRANDSON

I have enjoyed a time gone forever.

You are graduating into a time I would not understand

My gift to you are thoughts from many.

Life is a journey, not a goal.

Simplicity is the key to contentment.

Wants and desires change from one day to another.

You have only learned how to learn.

If you dream it, you can do it.

Experiences in life are priceless memories stored.

Make each day count.

Do all things well.

When your plans are ruined; plan again.

Failure is not the end, quitting is the end.

Take time to play, have fun and laugh.

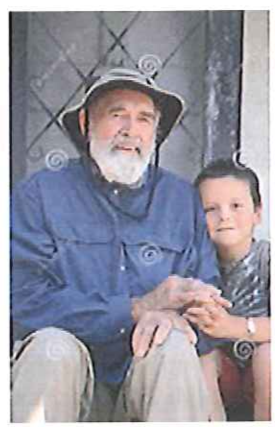
Marry a happy family, the wife comes with them.

Always be yourself.

No success is greater than developing self-respect.

Love and Godspeed,

Grandpop



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