

The Potentially Life-Changing Words of Adam Smith **Jim Whiddon**

Author Russ Roberts takes an interesting tack in his new book, “How Adam Smith Can Change Your Life.” While Smith’s most famous tome, “The Wealth of Nations,” has been most popular in economic and investor circles, his other volume, “The Theory of Moral Sentiments,” contains some of the venerable writer’s most valuable insights.

One of the lessons investors can learn from this offering is that investing truly is more about behavior and less about the numbers. It’s not the charts, but our hearts that direct our decisions about money. And this concept is what Smith was so adept at teaching us.

Roberts brings this truth to our attention masterfully. Let’s take a fresh look at some of the more momentous free-market concepts that Smith endorsed, along with some astute commentary from Mr. Roberts.

Early on, Roberts addresses a widely-known notion for which Smith is duly famous: “People are fundamentally self-interested, which is not the same thing as selfish.” This famous passage from 1759 is evidence:

“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.”

Here, Smith has identified one of the fundamental building blocks of free and efficient markets. Simply put, folks tend to look out for themselves and those they care about. This type of caring action brings together the interests of all in order to meet the needs of all. It’s not a centralized, organized plan. It simply happens naturally, in every culture with every human being, if it is allowed to do so.

When you break it down, this simple fact of human nature provides investors with something to invest in. In modern society, that often means companies where boards and executives take risk and pursue profits to meet the needs of themselves, their employees and their customers.

Secondly, there have been many excellent books written in recent decades concerning a field we investment advisors enjoy following – behavioral economics. In addressing this intersection of psychology and economics, Roberts explains the Narrative Fallacy, in which “evidence that fits a certain narrative is noted after the fact. Other evidence that doesn’t fit the narrative is discarded.” In other words, it’s a play on the well-known behavioral finance concept of confirmation bias.

Roberts says, “Everyone can explain why the stock market rose or fell yesterday. No one can predict what it will do tomorrow. It’s all just ex post facto storytelling. Sometimes even the best quantitative analysis is worse than none at all because it gives the illusion of science.”

In the investing arena, active managers have diligently honed their ability to accurately tell the “story” behind why something just happened. Their goal is to then convince investors that this story-telling ability extends to events that will happen, and that this “skill” is equally valuable to their explanatory hindsight. I call this (tongue in cheek) the Crystal Ball Fallacy.

My favorite of Roberts’ citations is based on Smith’s quote, “the eye is larger than the belly.”

This one resonates with me personally because my father so often told me at the dinner table, “Your eyes were bigger than your stomach.” Who knew he was quoting a guy named Adam Smith?

This intersects with what is perhaps Smith’s most notable and popular adage:

“They are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society, and afford means to the multiplication of the species.”

The “invisible hand” gets all the attention, but I believe the most important phrase in this passage is “without intending it, without knowing it.”

Humanity’s simple and natural ambition, otherwise referred to as “greed” in its aberrant form, is such that it not only causes a person to look after his own, but the lack of satiated desire for “more wealth” unwittingly provides an avenue for those with less skill, talent and resources to also have the vocation to provide for their own on a global scale, thus taking it well beyond the local butcher or baker.

Here is the remainder of what Smith offered in this passage:

“When Providence divided the earth among a few lordly masters, it neither forgot nor abandoned those who seemed to have been left out in the partition. These last too enjoy their share of all that it produces. In what constitutes the real happiness of human life, they are in no respect inferior to those who would seem so much above them. In ease of body and peace of mind, all the different ranks of life are nearly upon a level, and the beggar, who suns himself by the side of the highway, possesses that security which kings are fighting for.”

As Roberts explains, “This is the only time that Smith uses the metaphor of the invisible hand in The Theory of Moral Sentiments. And he uses it only once in The Wealth of Nations. In both cases, it means that self-interest can lead to benefits for others—hardly the grander interpretation some place on it today.”

So Roberts (through Adam Smith) delivers a deeper understanding that:

- Self-interest (not selfishness) can paradoxically help everyone in the community.
- Confirmation bias disguised as forecasting expertise is suspect.
- The wealthy must help others in some way on their own way to “getting more,” because the system naturally demands it be so.

This is an important three-part lesson to remember when it comes to our free market economic system and the benefits we enjoy. As hard as we may try in this technological algorithmic age to make investing all about the numbers, there is an inescapable connection with our actions. Both individually and collectively, our economic decisions affect the outcomes, and thus simultaneously provide the unique advantages of the “invisible hand.”

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Previously, James founded and served as CEO for JWA Financial Group, Inc. in Dallas. He is a financial writer and speaker. He is the author of *Wealth Without Worry* and *The Investing Revolutionaries* and has been the host of “The Investing Revolution,” an investment radio talk show on CNN 1190 in Dallas.

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