Recognizing a mind divided

How to make and keep financial plans on track

Why is it so easy to know your own mind when it comes to sports teams and pop stars, yet it can seem almost painful when you have to make decisions about financial goals and the best options for achieving them? The reason may actually be rather simple: We come by this aversion naturally. Essentially, we are all of two minds when it comes to how we process information.[1]

How your mind really works

Our capacity for complex reasoning — what makes us human — evolved over time. But, the instinctive portion of our brains, which helps prevent loss by perceiving and reacting quickly to situations of uncertainty, is considered to be original equipment. This reflexive, more dominant portion produces the near-instantaneous and emotionally driven "flight or fight" response that is so critical to our basic survival.

As a result of our mental duality and the accompanying difference in processing speeds, we tend to feel before we think. And it's this duality — and the instinctive mental biases it may give rise to — that can also be at play when many of us approach planning and other activities that require us to decide among complex options. These activities require us to slow down and do more thinking than feeling.

[1] *Nudge: Improving Decisions About Health, Wealth, and Happiness*. Richard H. Thaler and Cass R. Sunstein, Yale University Press, 2008.

What are behavioral biases?
These are instinctive, cognitive and emotional shortcuts.
When left unchallenged, they can undermine decision-making.[2]

What does this have to do with our finances and investing?

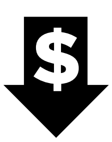
Financial decisions involve complexity, the very thing that is most likely to frustrate our basic instincts. From understanding the potential impact a specific financial product's future performance will have on retirement savings, to what type of mortgage will be more beneficial for any given situation, there is a lot to think about.

When your natural instinct is to make rapid assessments of a situation, being forced to stop and think things through can feel uncomfortable for many of us.

For this reason, we tend to simplify when faced with complexity, which can lead to relying too heavily on mental short cuts, or behavioral biases. These biases can help, but they can also undermine the effectiveness of our financial decision-making.

Recency bias
For instance, consider recency, a bias that leads to projecting the recent past out into the future. An example of this can be found in the housing bubble that burst in 2008. At the time, many homeowners had become convinced that their home's price could only go up, because that is what it had been doing for a number of years. This led quite a few homeowners to leverage their home equity to pay for a more expensive lifestyle than could comfortably be afforded through household income alone. When home prices declined, many homeowners faced increasing financial problems, unable to afford their higher home loan payments and the upkeep on their new lifestyles.

Ambiguity (uncertainty) bias
Another common bias involves *ambiguity*, or uncertainty about financial decisions. For example, after a significant market decline, many investors panic over stock market volatility and sell most or all of their stocks and invest in bonds. Stocks and bonds, however, are not "opposites"; they can move in the same direction. Choosing one over the other can potentially impair long-term investing goals.



Loss aversion bias
Then there is the aversion to potential loss, a universal bias with major financial implications. No one likes to lose, especially money. In fact, studies have found that the pain of loss is far more intense than the pleasure we feel from a gain.[3] Due to this aversion for loss, some people will cling to investments long after they should be sold to avoid the pain of disappointing results.

[2] The field of behavioral finance delves deeply into these biases and their impact on decision-making. It relies heavily on the collected works of Daniel Kahneman and Amos Tversky, widely regarded as the "founding fathers" of the behavioral finance field among others.
[3] *Thinking, Fast and Slow,* Daniel Kahneman, Farrar, Straus and Giroux, 2011.

The role emotional experience plays

While behavioral finance experts characterize us as bouncing between a state of instinct and one of reasoning, we do it to different degrees and with varying amounts of success throughout our lives. Arguably, that success has something to do with our emotions and experience.[4]

While psychologists have identified many biases, here are a few more that commonly impact financial decisions:

- **Hindsight:** We tend to remember the past as having been predictable
- **Framing:** This occurs when the same information is interpreted differently based on the way the information is presented
- **Anchoring:** When making decisions, we have a tendency to use one piece of information as an "anchor," which influences how we view the rest of the information we have.

How to counteract biases

A study regarding investor behavior during the 2008 financial crisis found that people who were more pessimistic tended to overreact to the financial panic and ultimately locked in their losses. They inadvertently realized their greatest fear — the permanent loss of their savings. People with greater market experience and those more likely to focus on the potential for gain in spite of risk, tended to hold instead of sell. These individuals rode through the volatility and ultimately came out of the crisis with their investments and financial plans still intact.[5]

While we can't change our immediate emotional responses, we can be more aware of how they're triggered and how they can impact our decisions. By increasing our understanding of which biases we are most prone to, we can improve our ability to make financial decisions that are truly in our best interests. It's this belief that has caused some leading financial companies to create financial personality assessments.

Companies increasingly use assessment tools to assist individuals and their advisors in understanding which biases may be most problematic, given each individual's emotional traits. Over time, this helps advisors and clients have more insightful, targeted discussions that may improve investors' overall comfort level and ability to make more rational and less emotional decisions about their financial plans.

[4] *An Intimate Portrait of the Individual Investor*, Robert B. Durand, Rick Newby and Jay Sanghani, (2006); Robert B. Durand, Leila Peggs and Michelle Siekierka, "Personality," May 2010.
[5] *Which types of risk tolerance questions should be used when determining a client's portfolio allocation preference?* Journal of Financial Planning, Michael A. Guillemette, Michael Finke and John E. Gilliam, Vol. 26, No. 5, 2012, 34–42.

An advisor's role

When it comes to our mental world — especially when it comes to financial decisions — we not only expect to power through despite our limitations, but we assume we will be rational and expertly weigh our options with full objectivity. By becoming more aware of the short cuts we may be taking, we can avoid overreacting to new information and think things through more carefully.

To help balance the rational versus emotional, relying on a trusted advisor can help us achieve and maintain our objectivity. In addition to being great resources for establishing financial plans and devising strategies for achieving them, advisors are the primary defense against letting biases defeat financial goals.

Work with your financial advisor to learn more about how to keep behavioral biases from impacting your investing decision making.

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