BEHAVIORAL FINANCE 101 - A SUMMARY

Behavioral finance is also sometimes called behavioral economics or investor psychology. It sees investors as “normal,” not rational, and also observes that markets sometimes don’t function efficiently, but tend to overreact.

So, how does this framework impact our financial decision-making? In answer to this question, we have explored a number of typical biases and/or thinking patterns that - for the "normal" investor - could play a role. Here's a review.

Cognitive and Emotional Biases

A cognitive bias is a tendency to think in a certain way, such as a rule of thumb that may or may not be true. For example, if you see a man dressed up as a policeman, you assume he is a policeman. An emotional bias is a mental state that arises spontaneously and is related more to impulses and intuition than to thinking. Read more about cognitive and emotional biases.

Illusion of Control

We often think we have more control over an outcome than we actually do. For example, thinking that choosing your lottery ticket number vs. receiving a randomly assigned number will enhance your odds of winning. For investors, illusion of control can lead to excessive trading or a poorly diversified portfolio. Read more about the illusion of control.

Availability

The availability bias is a mental shortcut to estimate the probability of an outcome based on how easily it comes to mind, such as a recent advertisement for a product that steers your purchase decision. It might lead you to overinvest in a company or industry you work in or in something that matches your personal interests, but is inappropriate for you. Read more about the information processing bias of availability.

Self-Control

This is an emotional bias where people fall prey to short-term thinking and may fail to focus on long-term goals. It could lead to living high today, but not saving sufficiently for the future. Learn more about the impact of self-control on financial decision-making.

Loss Aversion

We don't like losses, and the pain of losing a dollar exceeds the joy of gaining a dollar. Our aversion to losses could cause us to avoid selling a poorly performing investment because by holding on we postpone the pain of selling it and making the loss real. Loss aversion results in over-focusing on the short-term volatility of a portfolio, instead of the expected long-term performance. It also makes you myopically examine each individual investment, losing sight of the big picture. Read more about loss aversion.

Endowment

Simply owning an item causes us to overvalue it. We often become emotionally attached to an investment we inherit from our parents or stock in the company we work for. Ask yourself, "If, instead of owning this particular asset, I had the value that it represents in cash, would I go back today and buy it at all – or in the same amount that I own today?" Read more aboutendowment.

Regret

None of us go through life without some regrets. The memory of bad decisions and the fear of regret may cause you to be too cautious in your future investment decisions, ultimately leaving you far short of accumulating the money necessary to accomplish your life goals. Read more about the role ofregret on financial decision-making.

Status Quo

Status quo is an emotional bias causing us to do nothing instead of making needed changes, resulting in poorly designed portfolios or investments that are no longer aligned with our goals. For example, employees rarely alter the investments in the 401(k) retirement plans. Read more about status quo.

Optimists & Pessimists

Optimism is a good thing, but could also lead us to overestimate our skills and knowledge and be overconfident, taking unnecessary, excessive risks. On the other hand, the dour pessimist puts more weight on negative events and constantly focuses on the worst possible outcomes, despite their low probability of occurrence. Read more about optimists and pessimists.

Herd Behavior

We often follow the opinions of the crowd and move with the herd, and this makes us feel safer and helps avoid conflict – and sometimes it is the smart thing to do. However, at the turning points – the extremes – the crowd is precisely and dramatically wrong. But, it is difficult and uncomfortable to walk to your own drummer. And, while being a "contrarian" investor may be a successful investment strategy, it is rarely followed. We find it more palatable to fail conventionally while following the crowd than to excel unconventionally. Read more aboutherd behavior.

Anchoring

Our minds are anchored by things that should not, but do, affect future decisions. If you paid $50 for a stock and it drops in price to $40, what should you do? The $50 purchase price is important for tax reasons, but other than that, it means nothing with the “sell” or “keep” decision. Read more about anchoring.

Mental Accounting

Do you sometimes divide your money into different virtual “mental” accounts based on some arbitrary classification and treat each account differently? Some examples: a “salary” account vs. an “inheritance” or “bonus” account; a “windfall” account vs. a “long-term” account. There can be valid reasons for these virtual accounts, but they can also have negative consequences, such as spending the money in your “windfall” account on something frivolous. Read more about mental accounting.

Recency

The recency bias convinces us that new information – which is more recent – is more valuable than older information. Now, this may be true, but not necessarily. If one recent economic statistic is negative, we weigh it much more heavily than many other statistics, which might be more positive. Read more about the role of recency bias on financial decision-making.

Hindsight

We see perfectly when we know the final outcome and look backwards, but life is lived forward, and things that seem so clear when looking backward appear rather murky when gazing forward. With hindsight bias we may not learn from past mistakes and may also consider poor decisions that had positive outcomes to be smart strategies, while viewing well-thought-out decisions that unfortunately had negative outcomes to be mistakes. Read our article on hindsight.

Framing

The way that a question is asked, or “framed,” affects how it is answered. Framing can be used in a positive way to prod us to do things we really need to be doing, but it can also be used to manipulate us into acts that benefit others, but perhaps not ourselves. Read more on framing.

Confirmation Bias

We tend to pay more attention to things we read or hear that agree with or confirm our existing worldview while tuning out ideas and opinions that challenge our worldview. It is a difficult and ongoing task for all of us to maintain intellectual honesty with ourselves. Wrestling with new information sharpens our thought process, and at a minimum leaves us better equipped to defend our current beliefs and opinions. Read more onconfirmation bias.

We hope you have enjoyed our Behavioral Finance Series this year and we hope that this knowledge informs your financial decision-making process. At the micro – personal – level, we all routinely exhibit faulty logic and have biases. While we may not be able to eliminate or even change our thinking and biases, if we can learn to recognize them, perhaps we can at least learn to harness and control them.

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