BEHAVIORAL FINANCE 101 - FRAMING

The two European countries were adjacent to each other with similar cultures. In one country, the number of people signing up to be organ donors upon their death was very high. Surprisingly, in the neighboring country, it was the exact opposite, with very few donors. What could account for such a wide discrepancy?

In the country with the *high percentage*of organ donors, people renewing their driver's license had a checkbox at the bottom, and an accompanying statement which said "Check the box if you do not want to be an organ donor." Very few people checked the box. The country with a *low percentage* of donors also had a checkbox and statement on their driver's license renewal, but the statement said "Check the box if you do want to be an organ donor." Again, very few people checked the box.

This is a good example of the "framing bias" – the way a question is asked affects how it is answered. Perhaps it also illustrates that we tend not to read things as carefully as we should – but that's another issue.

A similar result to the organ donation is achieved today when people are work at companies offering 401(k) retirement plans. We all need to save for our retirement, but it is hard to save and we also want and need all the cash flow we can get today. Not surprisingly, 401(k) participation increases dramatically when it is an "Opt-Out" procedure (check the box if you do *not* want to put 3% of your paycheck into the 401(k) plan) vs. an "Opt-In" procedure (check the box if you *do* want to put 3% of your paycheck into the 401(k) plan).

Framing can be used in a good way to prod us to do things that we really need to be doing, but it can also be used to manipulate us into acts that benefit others, but perhaps not ourselves.

Suppose you are told that lottery #1 has a 10% chance of winning, while lottery #2 has a 90% chance of losing – which ticket would you buy? Well, you shouldn't waste your money on either one, but although the odds are really the same on both, doesn't lottery #1 sound more inviting and positive?

In portfolio management, we also distinguish between "narrow framing" and "broad framing."

Narrow framing happens when we focus on specific aspects of an investment or on a particular investment rather than the portfolio as a whole. An investor adopting a narrow frame evaluates each investment in isolation from the big picture of the entire portfolio. In contract, **broad framing** might be viewed as "big picture thinking" - i.e., the connection of long-term financial goals to your portfolio as a whole.

Narrow framing and loss aversion go hand-in-hand. In this case, because the investor wants to avoid regret and losses, they over-focus and fret over the performance of each individual investment and ignore or fail to understand that a well-diversified portfolio requires a variety of investment types.

Narrow frames are the enemy of diversification.

Clients must also work closely with their advisors to make sure risk tolerance questions are framed correctly and that their answers correspond to the correctly-framed question.

Consider these two questions:

1. Do you prefer investments with less volatility, so they don't jump up and down in value very much?

2. In order to reach your financial goals, are you willing to accept the normal market volatility of a well-diversified portfolio?

Now, no one really wants investments that bounce up and down, so the first question certainly sounds attractive to me. But, the second question connects my long-term financial goals to my investments and reminds me that in order to reach my goals, even with a well-diversified portfolio, I must be prepared for and willing to accept some degree of risk and volatility.

I believe the second question is framed in a much better way and connects with the real issues involved.

This article is part of our ongoing series on behavioral finance which explores how our thoughts and feelings affect our financial decision-making. Some of the topics covered include Loss Aversion and Endowment, Regret and Status Quo, Herd Behavior, Anchoring, Mental Accounting, Recency Bias and Hindsight. Increased awareness of these tendencies and biases can lead to better financial decisions.

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