BEHAVIORAL FINANCE 101 -REGRET & STATUS QUO

Regret

None of us go through life without some regrets. Perhaps you should have accepted that job offer some years ago. On the other hand, maybe you did accept it and now wish you hadn't. How about your choice of what to study in college or the house you did – or didn't buy?

Regret involves decisions both of commission and omission, but studies reveal that we regret more the bad decisions we did make (commission) than decisions we simply failed to make (omission).

Regret is pervasive – everyone feels it. We've all had conversations that started with, "If only I had….."

Regret influences our decision-making. We really don't want to hear that a different path might have been a better alternative, so we often block even receiving that type of feedback.

Regret can be helpful, teaching us to learn from the past and to make better future decisions, but it can also be misleading, such as when your well-crafted investment portfolio drops during a general market decline. Regret is also painful, and may cause you to lash out and seek to blame someone else for an undesirable outcome that is really not their fault.

We talked last month about loss aversion and how we don't like to realize a loss, so we might put off selling a poorly performing stock in order to avoid admitting that a loss has actually occurred. Regret is closely tied to loss aversion because realizing a loss brings the pain of regret when we find, in hindsight, that an alternative decision would have resulted in a happier outcome.

The memory of bad decisions and the fear of regret may cause you to be too conservative in your future investment decisions, ultimately leaving you far short of accumulating the money necessary to accomplish your financial and life goals. It can also cause you to fall prey to herding behavior, following the crowd and buying what is hot or popular just because it becomes easier to rationalize a poor investment decision if many people lost money on it, and not just you.

Even investors who pride themselves on their cold logical thinking are vulnerable to regret when the market continues to perform opposite from their sophisticated quantitative models suggest.

We constantly hear that we must "eliminate emotion" in our financial decisions, but emotion is not going away anytime soon. But, we can at least try to recognize it and reduce its impact in our thought process.

Status Quo

Status Quo is an emotional bias where people tend to do nothing instead of making a change. Even when a person knows some kind of change is needed and would probably be beneficial, we are more comfortable keeping things the same than taking the time to research and implement a change.

A consequence of status quo is that you might continue to hold a portfolio with inappropriate risk/reward characteristics or a portfolio that no longer is aligned with your long-term goals. Many studies indicate that employees rarely alter the allocations in their 401(k) plans.

How do you deal with a status quo bias? You must train yourself to regularly look for new opportunities. Review your overall asset allocation periodically to ensure a proper allocation is maintained.

However, a word of warning is also in order. Perhaps there is nothing wrong with your current portfolio. Don't confuse the advice of reviewing your investments and allocations with a need to constantly be making big changes, bouncing like a ping pong ball from one strategy to another – that is truly hazardous to your financial health. The apple tree needs to be pruned periodically, but you probably don't need to chop it down and plant a pear tree.

In what ways has behavioral finance impacted your decisions? We're here to help as you plan for your future.

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