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PART THREE

From the Outside Looking In

By: Rex Moxley

What would you do with a million dollars?

"If I had a million dollars..." is a refrain often spoken and contemplated. From song lyrics to day dreams, we spend time fantasizing about what we would do with such a large sum of money. For many, accumulating a million dollars seems unattainable, but in reality, it can be achieved. The keys are: utilizing a predetermined and dedicated savings/investment program, sticking with good financial management, and making smart choices.

Of the three items listed above, the piece that is often ignored is “making smart choices.” In fact, what we think are *smart* choices may be the exact opposite, they could be *emotional* reactions to something going on in our world at the time. This paper, part three of a series, uses the tenets of behavioral finance* to examine how and why our actions often impede smart financial decision making.

In part one, we introduced the topic of behavioral finance and how our biases can prevent us from making the best financial decisions. We discussed three common and powerful biases: loss aversion, conservatism, and hindsight. In part two, we discussed three more biases: present bias, bandwagon, and overconfidence. In both papers we explained how biases impede smart financial decision making. We, and many researchers, believe that by identifying the biases behind many of your financial decisions, you can effectively change your behavior and ultimately become a better informed and successful investor.

BACKGROUND

We spoke in parts one and two about the two systems in the human brain that help with decision making— the automatic, emotional one (which generates our impressions, intuitions, and feelings) and the intentional, rational one (which uses logic to enable us to perform complex computations). In most cases the two systems work together to help us make decisions. We open the closet and think, “What do I want to wear today?” System one says, “The grey short-sleeved shirt.” But system two says, “Wait, it is getting cooler out, take a sweater too.” The two systems work in harmony.

However, when it comes to financial decision making, it’s harder for the two systems to work in harmony. System one uses biases or emotional road blocks to make decisions. System two then must recognize the bias and then intentionally use logic to assess the decision and potentially overrule it. The goal is to use the rational side of your brain to come up with a better and more reasoned “final answer.”

Here are three of the common biases that can detrimentally affect your goal, be it “a million dollars” or saving enough for retirement.

MENTAL ACCOUNTING/ SEPARATE BUCKETS

Have you heard the "Legend of the Man in the Green Bathrobe?" It tells the story of a man in Las Vegas and how he turned a $5 bet into $262 million in winning. After the enormous streak of wins he experienced to get to $262M, he made one final bet and lost it all –the entire $262 million. The story goes that his reaction was, "Oh well, tonight I only lost $5."

The story illustrates the idea, developed by the Richard Thaler at the University of Chicago, that people have a tendency to code, categorize and evaluate economic outcomes by grouping their assets into separate, non-interchangeable mental accounts.[1]

People have a tendency to code, categorize and evaluate economic outcomes by grouping their assets.

As an illustration of this concept consider these two scenarios:

1. You purchased a ticket to a special event for $150. When you arrive at the venue, you find you've lost the ticket. Do you buy another $150 ticket?
2. You go to the event planning to buy a ticket at the window. When you arrive, you find you lost the $150 you had set aside in your pocket. You still have enough money in your wallet. Do you buy the ticket?[2]

In a study by Amos Tversky and Daniel Kahneman, the majority of people answer "no" to 1 but "yes" to 2 because they think of the $150 loss in different ways. Their mental accounting changed based on the scenario. In scenario 1, the price of the lost ticket and price of a replacement came from one mental "bucket" – and people thought, "I'm not willing to spend $300 for a ticket that should have cost $150. In contrast, the lost cash mentally came from a different budget; "I'm still spending $150 on a ticket, I just have $150 less to spend on something else."

1 Richard Thaler, "Towards a Positive Theory of Consumer Choices," *Journal of Economic Behavior and Organization 1* (1980):39-60.

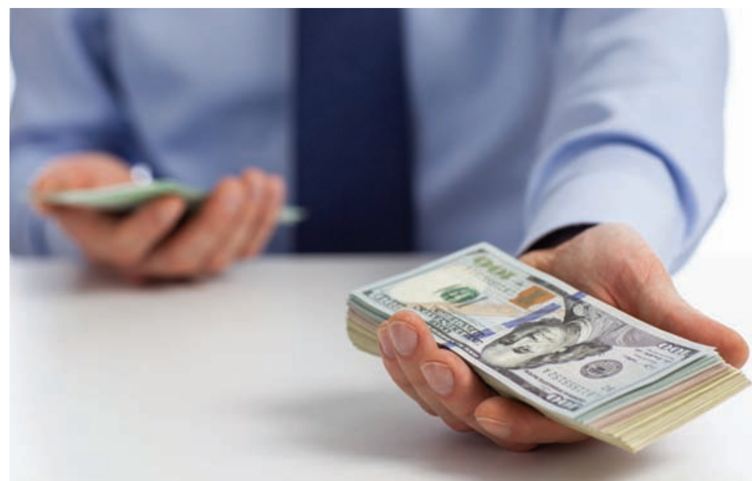
2 Amos Tversky and Daniel Kahneman,"Rational Choice and the Framing of Decisions" *Journal of Business 59* (1986):S251-S278.

This type of mental accounting can cause investors to imagine that their investments are in separate "buckets" and treat each "bucket" differently. They think, "I need to be conservative with my retirement money, but can be more aggressive with my vacation money."

Mental accounting also causes people to treat money differently based on its source. "Found" money from an inheritance or a win at a casino is often treated more irreverently than "earned" money from a salary. The risk of mental accounting is that "By assigning relative values to different moneys that in absolute terms have the same buying power, you run the risk of being too quick to spend, too slow to save, or too conservative when you invest."[3]

Are you biased?

1. You're planning to buy a new television. You've done your research and found the best one for you. It costs $750. You get to the store, and there is a newer, sleeker model with better resolution available. However, it sells for $1,000. You remember you won $100 playing the lottery last weekend. Do you buy the more expensive model?
2. You're planning to buy a new television. You've done your research and found the best one for you. It costs $750. You get to the store, and there is a newer, sleeker model with better resolution available. It sells for $1,000. You put your hands in the pocket of your jacket and find a check for $100 from your mother. In the note it says, "For a rainy day." Do you buy the more expensive model?



Mental accounting also causes people to treat money differently based on its source.

If you, like most people, answered "yes" to question 1 and "no" to question 2, you are susceptible to the mental accounting bias.[4]

How to overcome the bias: How to overcome this bias varies based on how the bias manifests itself. If you are prone to spending "found" or "unearned" money relatively carelessly, train yourself to wait a week before making any big purchase decision. Try to remember that every dollar is exactly that, a dollar, and that they all add up in the same way towards reaching the $1 million goal we spoke about early.

If you are prone to investing in "buckets," speak to an investment manager to get an outside view of the big picture and determine how your individual investment philosophies are working together toward your overall financial well-being. Diversification is good, but should reflect your entire financial picture, not just your "retirement money."

3 Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes* (New York, NY: Simon & Schuster, 1999):33-34

4 Michael Pompian, *Behavioral Finance and Wealth Management- How to Build Investment Strategies That Account for Investor Biases* (Hoboken, NJ: John Wiley & Sons, 2012):128-130.

DECISION PARALYSIS

Do you remember the movie, *Short Circuit* where a robot character came to life? He was trying to learn about the world, and ran around constantly saying, “Need more input.” Many of us act in a similar fashion. We seek as much information as possible before making a decision. While information is extremely valuable, at times too much information negatively affects the accuracy and timeliness of decisions. There are numerous studies which show this to be the case both in the real world and the investment world.[5]

For example, a recent TIAA-CREF survey showed that “the number of investment choices in a retirement plan makes a critical difference in employees’ confidence regarding the adequacy of their retirement savings. ...Nearly two-thirds (65%) of those who think they have too many investment choices are very or somewhat concerned about running out of money in retirement.... By contrast, 40% of respondents who feel they have the right number of investment choices are “not at all concerned” about running out of money in retirement.”[6]

One would think that younger Americans, with all of their tech savvy, would be better situated to handle more information. However, another study showed that not to be the case. According to a recent article in The New York Times, only 43% percent of eligible workers under 25, and 62% of those between 25 and 34 participate in 401(k) plans, due in part to having too many choices. Typically, these young Americans also tend to keep about half of their portfolios in cash.[7] Obviously, this may be partially the result of commanding lower salaries and the 2008 market correction.

Are you biased?

1. Imagine you are thinking about buying a new printer, but you haven’t decided on which brand to go with or how much to spend. You get an email from Staples offering a special deal on the Canon MX922 All-In-One printer. It’s $100 off! *Do you buy the printer or research other models?*

2. Imagine you are thinking about buying a new printer, but you haven’t decided on which brand to go with or how much to spend. You get an email from Staples offering a special deal on the Canon MX922 All-In-One printer. It’s $100 off! You visit the Staples website and see that the HP Officejet Pro 8610 e-All-In-One printer is also on sale; $50 off. *Do you buy the Canon, buy the HP, or do more research to ascertain why there’s a price difference and maybe compare other models?*

5 James Montier, *The Little Book of Behavioral Investing: How Not to Be Your Own Worst Enemy* (Hoboken, NJ: John Wiley & Sons, 2010):7385-130.

6 https://www.tiaa-cref.org

7 Steven Rattner, Saving Young People From Themselves, “The New York Times”, April 12, 2014.

If you said buy the Canon in scenario 1, but do more research in scenario 2, you are like the majority of Princeton and Stanford students who were presented similar hypothetical scenarios. In scenario 1, only 33% of the students said they would do more research, but in scenario 2, 46% wouldn't buy either printer. The more choices faced, the harder it is to make a decision.[8]

How to overcome the bias: Focus on what really matters. Jean-Marie Evillard, of First Eagle, who has earned a Morningstar Fund Manager Lifetime Achievement Award explains, "It's very common to drown in the details or be attracted to complexity, but what's most important to me is to know what three, four, or five major characteristics of the business really matter."[9] Pick your own 3-5 favorite elements. Maybe they are valuation, balance sheets, capital discipline, growth characteristics, industry and stick with them.

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STATUS QUO BIAS

A similar bias to decision paralysis is the Status Quo Bias. Simply put, people are resistant to change. This bias can cause investors, by taking no action, to hold investments that are no longer suitable for them based on their risk profiles and time horizons. In many cases, an investor feels tied to a holding for an emotional reason—it was held by other family members, it's the result of a stock option, they "like" the brand.

Are you biased?

Your portfolio has been performing "ok," but your financial advisor recommends you rebalance it to more accurately reflect your current and future needs, and changes in the market. The changes in the portfolio may mean incurring some tax liability. Do you:

1. Think about it, look over your current portfolio, and get back to your advisor in a week to hear what he has to say?
2. Think about it, but decide that since it is ok, why make any complicated changes? Your thinking is: "If it ain't broke, don't fix it."

8 Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes* (New York, NY: Simon & Schuster, 1999):83

9 James Montier, *The Little Book of Behavioral Investing: How Not to Be Your Own Worst Enemy* (Hoboken, NJ: John Wiley & Sons, 2010):84..

Answer 2 reflects a potential for the status quo bias. This behavior can be hazardous to your wealth because a tax is frequently a small price to pay for properly allocating your assets.[10]

How to overcome the bias: While doing nothing is often the short-term easy answer, it is often not the best long-term solution. Ask yourself, "Have I rationally thought about this change; the why I should or should not make it." Articulate out loud the pros and cons to a friend or family member. Using words helps move the decision out of the emotional side and engages the rational side of the brain. Ask a second, trusted source, for his/her opinion. (Don't ask too many people otherwise you may wind up with too much data.)

Let a professional, trustworthy financial advisor serve as your "outside view."

CONCLUSION

It's easy to let emotions influence decision making. Our brains contain a powerful system that helps us solve hard problems quickly. It's difficult to activate the rational side.

Let a professional, trustworthy financial advisor serve as your "outside view." A good financial advisor can help you stay on track and keep you focused on your goal – be it "a million dollars" or a secure financial future.

We hope you found this paper of value. We always welcome your feedback, so feel free to contact Rex Moxley (rmoxley@smithanglin.com) or Weston Pollock (wpollock@smithanglin.com), both members of our Educational Research team, via email or at our toll free number (800-301-8486) with any questions or comments. They can also be reached via our company website, www.smithanglin.com.

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10 Michael Pompian, *Behavioral Finance and Wealth Management- How to Build Investment Strategies That Account for Investor Biases* (Hoboken, NJ: John Wiley & Sons, 2012):226

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