Behavioral Finance

Behavioral finance studies is the psychology of financial decision-making. Most people know that emotions affect investment decisions. One of the most fundamental assumptions that conventional economics and finance makes is that people are rational "wealth accumulators" who seek to increase their own well-being. Over the past fifty years established finance theory has assumed that investors have little difficulty making financial decisions and are well-informed, careful, and consistent. The traditional theory holds that investors are not confused by how information is presented to them and not swayed by their emotions. But clearly reality does not match these assumptions.

Behavioral finance has been growing over the last twenty years specifically because of the observation that investors rarely behave according to the assumptions made in traditional finance theory. Our biases tend to sit deep within our psyche and may serve us well in certain circumstances. However, in investments they may lead us to unhelpful or even hurtful decisions. Behavioral finance suggest investors are more sensitive to loss than to risk and return. Some estimates suggest people weigh losses more than twice as heavily as potential gains. An example of an assumption about preferences is that people are loss averse—a $2 gain might make people feel better by as much as a $1 loss makes them feel worse.

Today I want to discuss just two of the various key concepts in behavioral finance: 'Mental Accounting', and 'Confirmation and Hindsight Bias'. Mental accounting refers to the tendency for people to separate their money into separate accounts based on a variety of subjective criteria, like the source of the money and the intent for each account. According to the theory, people assign different functions to each asset group, which often has an irrational and detrimental effect on their consumption decisions and other behaviors. For example, people often will have money put aside for a vacation, a new vehicle or college funding, while still carrying substantial credit card debt accruing at 20% or more annually. Simply put, rarely would this make financial sense.

Mental accounting bias also enters into investing. Our psychological self thinks about money and risk through 'mental accounts'- separating our wealth into various buckets. We often base these buckets or goals on a time horizon (such as 'retirement' or 'school fees'). Accounts can also vary in investment risk tolerance, investing some more aggressively than others. This natural tendency to create mental buckets also causes us to focus on the individual buckets rather than thinking broadly, in terms of our entire portfolio.

Our next key concept is called 'Confirmation and Hindsight Bias'. It is often said that 'seeing is believing'. While this is often the case, in certain situations what you perceive is not necessarily a true representation of reality. This is not to say that there is something wrong with your senses, but rather that our minds have tendency to introduce biases in processing certain kinds of information and events.

Behavioral finance offers no investment miracles, but perhaps it can help investors train themselves how to be watchful of their behavior and, in turn, avoid mistakes that will decrease their retirement portfolio.

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Steve is the CEO at Klaas Financial, inc. and is a CERTIFIED FINANCIAL PLANNER™ professional who helps clients prepare for retirement — the biggest transition of their lives.

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