FOCUS ON BANKING, FINANCE & INVESTMENTS

How bias, perceptions affect financial behavior, success

By ELISSA WURF
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Why are some people better savers than others?

More specifically, why are successful long-term investors able to delay gratification and invest well for their future, while others are not able to see past their short-term fears and desires?


Wurf

A review of the concepts of behavioral finance will give us answers – and tips that everyone can use to make better and more rational financial decisions.

Since the interplay of biology and life experience influence financial perceptions and decision-making, a quick review of human brain structure is in order.

Humans have a triune brain, made up of three distinct sections.

The reptilian brain is responsible for instincts such as survival, hunger, fear and aggression. The mammalian brain controls more complex motivations, emotions and memory.

The third section of the brain, the cerebral cortex, is the rational, planning and decision-making brain. However, the cerebral cortex can be "hijacked" by the reptilian and mammalian brains, influencing our rational interpretation and decision-making.

IMPACT OF SCARCITY

Our brain and past experience determine our view of how much is "enough." In turn, perceptions of abundance versus scarcity significantly affect our financial behavior.

In their book "Scarcity," Sendhil Mullainathan and Eldar Shafir suggest that when people view something in their lives as scarce – be it money, food or time – they over-focus on it. In essence, the authors suggest in their book that the reptilian brain focuses on fear and overpowers the rational brain:

"By staying top of mind, [scarcity] affects what we notice, how we weigh our choices, how we deliberate and ultimately what we decide and how we behave. When we function under scarcity, we represent, manage and deal with problems differently."

FIXATED ON THE PRESENT

Scarcity focuses our attention narrowly and causes us to lose sight of the broader picture.

During times of perceived financial scarcity, people fixate on near-term, looming bills rather than long-term goals such as creating an emergency fund and saving for retirement.

When the mortgage is overdue and money is tight, the annual furnace tuneup and roof inspection become low priorities, and just one problem can lead to a feast-and-famine spending cycle.

Other biases also can affect financial decision-making. Overconfidence can foster overly risky investment decisions, while irrational fears might cause one to attempt market timing – pulling out of an investment when there is an economic downturn, but then missing the opportu-

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GETTING THERE

To mitigate the impact of individual perceptions and biases on long-term financial goals, one can adopt several strategies:

- **Establish emergency savings** that give you breathing room when a crisis such as a roof leak occurs.
- **Create plans** that break larger financial goals into small, manageable action steps.
- **Anticipate barriers** and create "if-then" plans to deal with overspending (for example, "If I buy an unbudgeted item, I must then contribute the same amount to my savings account").
- **Simplify adherence to plans** by taking advantage of automation (for example, setting up automatic deposits to retirement accounts).

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only with you but also your other professionals.

The "two heads are better than one" approach seems to be both practical and effective.

YOU HAVE QUESTIONS

So now, you have the picture painted of what you are looking for.

What types of questions should you ask a financial adviser? Look at the C's as a starting point.

■ **Character**

Do you act as a fiduciary for your clients?

How do you charge for your services?

Can you provide an example of how you recently helped solve a client's difficult problem?

■ **Chemistry**

Does the adviser talk more about himself or herself, rather than you?

Is the adviser client-centric? In other words, does the adviser ask probing questions to determine your wants, needs and goals?

■ **Competence**

What is your educational background?

Do you have any advanced degrees?

How long have you been an adviser?

■ **Consultative**

Is the adviser more interested in selling his or her product or solving your needs?

Will the adviser coordinate your financial affairs with your other professionals, such as insurance, tax and legal experts?

How often will you meet and what services will the adviser provide?

Another option is to ask friends and family who they use. Have they had a good experience? Would they recommend their adviser for you?

One place to search is www.letsmakeaplan.org, which contains information about Certified Financial Planners, detailing their ethical standards and how to find one in your area.

LIFELONG RELATIONSHIP

Which adviser is right for you? The answer is simple: the one who will guide you in making a lifetime of financial decisions.

The adviser-client relationship is the same as any long-term friendship or relationship. The better they know you, the more they can tailor advice to your particular situation.

No two clients are the same, and neither is their advice.

Think deeply about your circumstances and where you need help. Doing so may simplify your search.

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expenses that are not reimbursed for such things as clothing (uniforms, tools and trades gear) or unreimbursed travel and mileage.

Job-related expenses for those who are self-employed have not changed.

So, whether or not your wallet expands or contracts will depend upon your personal financial situation.

The state, local and property maximum deduction, if you itemize, is now $10,000. This could hurt people with high property taxes, including those who live in school districts with high tax rates, according to Spradlin.

DEDUCTIONS VS. CREDITS

The alternative minimum tax has been changed, not eliminated. It may apply to some high wage earners, trusts, estates and corporations.

"A lot of people won't be filing AMT, because they won't fall under it," Spradlin said.

Spradlin cautioned against confusing tax deductions with tax credits.

"Tax credits provide a dollar-for-dollar reduction [in tax liability]," she said. A tax deduction, though, lowers the amount of income on which your tax rate is based.

"The child tax credit, for dependent children 17 or under, was doubled to $2,000," Spradlin said.

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nity to benefit from future gains.

EMOTIONAL DISTANCE

To reduce the risk of getting in one's own way when it comes to long-term investing, the best strategy for many may be to work with a trusted financial adviser.

The research of psychologists Fenja Ziegler and Richard Tunney suggests that when one is less emotionally involved in an outcome, more rational decisions are made.

A financial adviser who has emotional distance from a client's life can help ensure that financial decisions are rational (considering long-term wants and needs as well as short-term, emotionally pressing desires and fears) and take into account long-term value as well as immediate costs.

Using these strategies will keep fear-driven or aggressive risk-taking behaviors from overcoming an investor's rational brain, which will, in turn, make long-term financial goals easier to achieve.

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