Five Common Behavioral Biases that Lead to Bad Decisions!

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Investing one's hard-earned money can be stressful, especially given current market volatility and constant media attention. To make matters worse, Behavioral Finance experiments have documented biases – our unconscious beliefs that sway our judgments and can lead to irrational missteps.

Here are five of the more common behavioral biases that influence our money decisions. We all possess them, but are more likely to avoid bad decisions if we are aware of the bias.

1. Mental Accounting

Mental accounting is the concept that we treat money differently depending on its source and what we think it should be used for. The mental accounting concept means that we do not treat all our money as interchangeable; we link how it's spent to particular "budgets." This mental accounting exposes us to making irrational decisions.

<u>Consider the rationale for these real-world situations. Do any sound familiar?</u>

1. "My bonus is different than my paycheck. I deserve to be extravagant with my bonus money!"

2. "Can I have a higher amount of tax withheld from my paycheck? I always take a trip with the refund."

In each of these examples, people make rationalizations about their money, leading to sometimes irrational decisions.

2. Loss Aversion

Loss aversion is the tendency to be so fearful of losses that a person's focus when making decisions is more on avoiding losses than making gains. Research estimates that we fear the pain of a loss twice as strongly as we feel the enjoyment of a gain.

<u>Consider the rationale for these real-world situations. Do any sound familiar?</u>

1. "I know the position has gone down, but I will lose money if I tax-loss harvest and sell now."

2. "We fell in love with the vacation home, and our broker said there were many people interested in it. I want to make a bid over the asking price with no contingencies. We don't want to let this one get away, and who knows when there will be another one quite like it!"

Loss is inevitable because those seeking rewards must take a risk. Loss aversion tilts the scale toward avoiding loss vs. potential gain.

3. Overconfidence Bias

Overconfidence bias is the tendency to see ourselves as better than we are. Holding a false or misleading assessment of our skills, intellect, or talent can be dangerous in finance and capital markets.

<u>Consider the rationale for these real-world situations. Do any sound familiar?</u>

1. "You asked us to rebalance our portfolio considering the recent downturn. I think the market is in a downward spiral, and I am not interested in adding to the portfolio until we hit bottom!"

2. "Yes, I am still waiting for that promotion, and my bonus is down a bit this year, but I am confident that if I just 'hang in there,' I will be successful at this company.

I am a big fan of a positive self-image and an optimistic outlook about life, but overconfidence bias can have disastrous results.

4. Anchoring Bias

Anchoring bias occurs when people rely on pre-existing information or the first bit of information learned when making decisions.

<u>Consider the rationale for these real-world situations. Do any sound familiar?</u>

1. "There is no way I will spend $1,200 on a wedding cake. My first car didn't cost $1,200." (Steve Martin in the movie "Father of the Bride")

2. "This house for sale is a steal. There is one on the cul-de-sac that sold for 35% more."

In our fast-paced world, our anchoring bias uses quick information to reduce the cognitive load on our brains. This might not be effective in arriving at a college savings plan for your children based on what you paid for college.

5. Herd Mentality Bias

Herd behavior happens when you follow what others are doing rather than making your own decision. Herd mentality is often the root cause of the creation and subsequent bursting of economic bubbles. From the Dutch Tulip Mania in the 1700s to the Crash of 1929 to the 2007 Housing Bubble, we have had plenty of opportunities to learn from past mistakes. FOMO – the fear of missing out – is now part of our vocabulary, and it sounds better than herd mentality.

<u>Consider the rationale for these real-world situations. Do any sound familiar?</u>

1. "Why don't you recommend I invest in cryptocurrency? Everyone is making so much money."

2. "All my friends are downsizing and moving to Florida to save on taxes. I'm thinking of contacting a local realtor."

Researchers discovered that it takes a minority of just five percent to influence a crowd's direction – the other 95% follow the herd without realizing it. I would never think about starting "the wave" at a sporting event, but I will stand up when it comes my way!

Conclusion

We all face these psychological biases in everyday life, and if we don't recognize them, we will likely make suboptimal decisions. For important decisions, make sure the primary reasons do not include "everyone else is doing it", loss aversion, overconfidence, too little or outdated information, or letting spending decisions vary depending on the source of the money. Seek out competent financial guidance from someone you can trust, get a second opinion, or seek an alternative way to think about the impact.