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Financial Connections
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Understanding Financial Behavior

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Why oh why?
Why do we do the things we do even when we surely know better? The so-called new science of behavioral economics seeks to illuminate many of our most costly money mistakes so that they can be understood and corrected. In *Why Smart People Make Big Money Mistakes* (Simon and Schuster), authors Gary Belsky and Thomas Gilovich gather some lessons we can all learn from recent research on financial behavior. Here are some of my impressions of the principles they uncovered.

Pain of loss trumps pleasure of gain
Which would you rather sell, a stock that has gone down in value or one that has risen? Most of us would sell the one that has risen and hang on to the one that went down. Selling the losing stock confirms the loss while hanging on to it offers the hope of regaining its lost value. A wiser investor would recognize this bias and make such a decision based on the prospects of the stocks involved rather than their previous values.

"Sunk costs" are difficult to surrender
We've all experienced the difficulty of giving up something into which we have sunk a lot of our money, like a very old car. Sometimes one more repair will render miles of faithful service, and sometimes it only leads to even more repairs. A wise consumer needs to recognize that however much money has been previously spent, the "sunk costs" don't necessarily justify hanging on.

Some dollars are more precious than others
Have you noticed that when you win a few dollars in Las Vegas it is so easy to lose them back? You might bet higher, bet faster, or bet longer with these dollars than with others you brought along. All dollars have exactly the same value. The wiser gambler knows this and treats winnings as a return on investment. The same care should be given to the extra dollars gained from tips, overtime wages, tax refunds, and inheritances.

Too many choices create indecision
Once I went to buy a VCR that was on sale. I saw it. I liked it. I wanted to buy it. That was until the salesman took me up the line of more expensive VCRs that were also on sale. I got so confused by the other good choices that I left without buying anything. Good choices make for efficient decision making as long as the number and complexity of choices is easy to handle. Too many choices tend to delay decision-making in favor of further exploration and investigation.

Limited sampling breeds overconfidence
The current stock market has been delivering such great returns for so many that those with little experience may think that it is really easy to make big money with very little knowledge. Knowledge based on a limited time span and a limited number of examples can be dangerous. Becoming a wiser person means that we come to realize the distortion created by limited samples. Just as we come to realize that people don't always stop at stop signs, we need to realize that stocks don't always go up in value either.

Preconceptions bias information
When two people go to buy anything that one wants and the other doesn't want, the product information processed by each usually fits the preconceptions of each. In other words, people tend to believe what they want to believe. We all knew that anyhow. But what is noteworthy is the degree to which irrelevant information is used to confirm a person's preconceptions. If you have ever started talking about car colors long before you decided on the make and model of a car to buy, you know the essence of irrelevancies and how much these can influence consumer decisions.

Engaging descriptions overshadow facts
Would you rather eat plain steak and potatoes or succulent medallions of beef with golden roasted potatoes? Studies show that consumers are more affected by engaging descriptions than by facts. The next time you read an advertisement, strike a line through every word expressing a whimsical quality and underline every word denoting an objective fact. Then re-read the advertisement to see if your impression of the advertised product or service is significantly changed. I'll bet it is.

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