Behavioral Finance:

How Emotions and Biases Can Drive Financial Decisions[1]

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Can our biases influence our financial decisions? The answer, some experts say, is absolutely and positively yes.

The field of study advancing this theory is behavioral finance, a discipline that pertains to personal and institutional decision-making in finance. A discussion of behavioral finance is worthwhile because investors of all descriptions may learn how certain biases can lead to decisions that adversely affect generating and retaining wealth.

Traditional financial theory assumes that people make financial decisions rationally, with undiluted future expectations. But those who follow behavioral finance say that is only sometimes the case.

Some examples from history can prove this point. Were you invested in the capital markets on Black Monday in October 1987? How did you respond on that day when the stock market had its biggest one-day percentage drop?

Economist Robert Shiller suggests the market crash occurred because investors believed it was coming. What did you do with your investments? Did you respond emotionally or take the long view? Did you move money into cash and bonds, the so-called safe havens? Or did you decide to ride out the tough times?

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On average, if you had left your investments as they were before the big drop, it would have taken only about two years to recover all your losses. Some investors became impatient during that amount of time and cut their losses. Others relied on historical performances of the market and maintained their positions, ultimately recovering everything and more.

Behavioral finance examines how individual psychology influences financial decisions, combining elements from psychology, finance and sociology. Behaviorists attempt to show how people react differently depending on the context of their financial choices.

Traditional finance theory differs from behavioral finance theory in some of the following ways:

Traditional	Behavioral
Decisions and behavior are consistent.	Various factors affect decisions.
People make decisions after carefully processing information.	People cannot process all the information they receive and make errors in judgment, even if the data is accurate.
The market is efficient and represents its true financial value.	The market is volatile, leading to many anomalies.
Risk is objective and can be calculated.	The willingness to take risks varies for each person and cannot be measured.

Most of us are loss averse, meaning we'd rather avoid a loss than gamble on a gain, even when the risks are equal. That's because, according to behavioral finance theory, we view losses and gains differently. We consider losses to be far worse than gains.

In other words, investors are more concerned with protecting against a loss than taking risks that could increase their wealth. When the choice is between protecting what you have versus gambling on an uncertain prospect, most investors choose the first option.

This concept is often referred to as prospect theory, conceived by Daniel Kahneman and Amos Tversky in 1979. Their study examined how investors viewed risk and reward differently.[2]

In one example from the study, subjects were told they would be given $1,000, then were asked to choose between a 50% chance of getting another $1,000 and a 100% chance of getting another $500. The majority took the sure thing. But in the next example, the subjects were told they would be given $2,000 and then were asked to choose between a 50% chance of losing $1,000 and a 100% chance of losing $500. This time, the majority took the bigger gamble, avoiding the sure loss.

In other words, they viewed the loss of $500 as far worse than the gain of $500.

The study aligns closely with the psychological bias of loss aversion when people tend to be more motivated by the possibility of losing money than by the chance of making money. Their aversion often leads investors to hold onto losing investments for too long in the hope that they will eventually recover their losses.

However, loss aversion is only one of several psychological biases that can affect financial decision-making. According to experts, these are some of the other most common biases:

Emotions

Emotions can have an oversized impact on financial decisions. Investors might take more risky actions when they are happy, for example. Yet when they are sad, they may avoid making any financial decisions at all. Feelings of anger, shame and joy can all trigger bad investment decisions.

Anchoring bias

People often give too much weight to the first information they receive during the decision-making process, leading them to make decisions that are not in their best interest. For example, someone anchored on a high price for a used car may be less likely to negotiate a lower price or look for a better deal.

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Confirmation bias

People will seek information confirming their beliefs and ignore information contradicting them. This tendency can lead investors to make decisions that are based on faulty information. For instance, an investor might hear a rumor that a company will declare bankruptcy and then seek only information that confirms that rumor and perhaps ignore a report that the company is about to roll out an exciting new product.

Herd mentality

People tend to follow the crowd, even when they know the crowd is making a mistake. This decision-making is often driven by a fear of missing out, which can result in financial bubbles or even panic, as happened with the dotcom run-up in the late 1990s and early 2000s.

Hyperbolic discounting

Sometimes referred to as present bias, this happens when investors give more weight to short-term rewards than to future rewards, even when the future payoff may be as good or even greater. Paying with credit cards is one example, ignoring that the long-term cost of the purchase will exceed the immediate gain.

Overconfidence bias

People tend to overestimate their abilities and underestimate the risks involved in making financial decisions. Overconfidence can make investors less cautious and willing to take on too much risk. Or they can overlook any evidence that doesn't confirm their bias.

Mental accounting

People who organize, evaluate and monitor their finances often segregate gains and losses into separate categories and can't see the optimal decisions across these categories. For instance, they will fund a low-interest savings account while carrying large credit card balances.

Here are some tips for overcoming those biases that can affect financial decision-making:

Be aware of your biases

The first step to overcoming a bias is to be mindful of it. Once you know that you are prone to a particular preference, you can take steps to mitigate its effects.

Take a step back

When making a financial decision, pause and think about it rationally. Don't let your emotions get the best of you.

Do your research

Before you make any financial decision, make sure you do your research and understand all the risks involved.

Seek help from finance professionals

If you are struggling to overcome your financial biases, consider seeking professional help from a KeyBank financial advisor.

Behavioral finance is a complex field, but it is becoming increasingly important for investors to understand. By understanding the psychological factors that influence your financial decisions, you can make better choices and improve your chances of achieving your financial goals.

For more information, please contact your advisor.

[1]This article summarizes key points from an article on Behavior Finance on moneygeek.com.

[2]Source: “Thinking Fast and Slow” by Daniel Kahneman

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