

Behavioral Finance and Counseling: Blunders and “Whys”



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What is Behavioral Finance?

- Exploring the interplay between economic theory and psychological reality.
 - Social science perspective is to study behavior of financial markets.
 - However, people make financial decisions based not on mathematical ideals, but on emotions.

Our focus is on the latter.

Application to Financial Counseling

- Many financial counseling techniques involve appealing to the rational mind.
- However, psychologists have found that individuals use both rational systems and automatic or intuitive processes¹.
- Irrational behaviors are seldom solved by rational solutions.
- Being able to recognize these processes in action is critical to developing successful action plans.

¹ Thaler & Sunstein (2008)

Overriding premise of personal finance education

- Individuals can learn from mistakes.
 - By identifying and understanding their behavioral economic shortcomings, individuals can correct them and enjoy more financial freedom.
 - To what other areas in our lives does this apply?

- Every financial decision should result from a rational calculation of the effect of the decision on one's overall wealth.

Should vs. *Reality*



- Fungible or Fungibility (fun'-ja-ble or fun-ja-bil'-ity)
 - Each dollar should have the same significance or value no matter the source, where it is stored or on what it is spent.

Should vs. *Reality*



Hybrid Vehicle – 50 mpg
 Price tag \$22,800
 Yr's fuel cost based on
 12,000 miles = \$648



Non-hybrid Vehicle – 33 mpg
 Price tag \$15,800
 Yr's fuel cost based on
 12,000 miles = \$981

Total cost difference of autos? \$7,000
 Total annual savings on cost of fuel? \$333

You would have to drive the Prius for 21 years to make up the cost difference on the car.

Factors That Influence

- Anchoring
- Endowment Effect
- Mental Accounting
- Decision Paralysis

Anchoring

- "Anchors" cling to a fact or figure that should have no bearing on one's judgments or decisions.
 - When estimating what we don't know, we use something we do know as a starting point, and estimate from that point.



The average engagement ring costs
2 to 2½ months' salary.

Principle	Anchoring
Explanation	Clinging to a reference point (fact or figure) which should have no bearing on one's judgment or decision; knowing the logical relevance to the decision at hand.
Counseling Example #1	<p>Any family of origin pattern that emerges.</p> <p>Can be informational: "Dad told me 'You have to keep some debt. Your credit score depends on it. If you don't have debt, you won't have a credit score, you won't be able to get a better job, your insurance rates are going to go through the roof, and where are you going to live?' "</p> <p>Can be behavioral: "In our family, when we needed some relaxation, we always went to Disney World."</p>
Possible Responses	<p>"Are you able to think of a few people you know who are functioning well without any observable debt?"</p> <p>"Where are some other places that people go to relax when they need a break?"</p> <p>"What is it about a place that makes it relaxing?"</p>

Principle	Anchoring
Counseling Example #2	"I've read where you are supposed to have 3 to 6 months of income saved. There is no way that I can ever do that with my salary and situation. So I figure, why bother?"
Possible Responses	"Everyone has to start somewhere. What if you saved \$5/week? Just to get a little saved to cover a flat tire?"

Principle	Anchoring
Counseling Example #3	<p>"We have been engaged for two months now and are finding some differences in our thoughts about money management. Both of us would like to have several children and I want to be a stay-at-home mom. My husband believes that would be a waste of my college education and that we should be a two-income family. I know that his mom worked, but that doesn't have to be the case for us, although it seems like all of our recently married friends have two incomes."</p>
Possible Responses	<p>"How do you think couples decide how much money is needed for the family to operate?"</p> <p>"Are there any other differences that you notice between yourselves and your family and friends?"</p>

Anchoring: Warning Signs

- Confident in their decisions.
- Financial decisions are made without much deliberation or outside research.
- Strong loyalty to certain brands or products without a reason.
- Focus on what was paid instead of value derived.

Endowment Effect

- "Endowment effect" – Thaler
 - Tendency to over-value what belongs to us relative to the value we would place on the same possession or circumstance if it belonged to someone else.
 - Housing market example



Your House
\$250,000



My House
\$350,000

Principle	Endowment Effect
Explanation	Tendency to fall in love with what one owns; over-valuing what belongs to an individual relative to the value he or she would place on the same possession or circumstance if it belonged to someone else; tendency to place an inordinately high value on what is "mine".
Counseling Example #1	"This car payment is a real pain in my budget. I know that I don't really need it. I'm walking to work and biking around town most of the time anyway. When I do need a car, my roommate lets me borrow his. I have \$4,000 in equity in the thing; that cash would make a great emergency fund. But, if I sell it, I don't think I can get what it's really worth."
Possible Responses	"If you are not driving your car, how do you determine its worth?" "In three years, how much will this car be worth?"

Principle	Endowment Effect
Counseling Example #2	"I am so angry with myself! This apartment is filled to the roof with an amazing amount of clutter. I am such a hoarder! Just last year we had to go rent a 10' X 10' storage unit to help hold all of my junk. I just can't bear the thought of getting rid of some of this stuff because I'll never be able to get for it what it's worth."
Possible Responses	<p>"Well, if you did sell all your stuff in storage, how much of a loss do you think you would incur?"</p> <p>"If the money you are spending each month from the cost of the storage unit was added together, how many months would it take to compensate for your loss?"</p>

Principle	Endowment Effect
Counseling Example #3	"I am so tired of going out for the evening and coming home with stuff that I never intended to buy. It happens almost every time! I'll go to the mall with friends and find myself trying on clothes for fun and ending up walking out with a bag full. Just last month I went with my cousin to help her car shop. After test driving a car with her, the salesman convinced me to take one for a spin. Can you believe that I bought it? Purchases seem like a good deal at the time, and rather harmless until the bills come in."
Possible Response	<p>"Do you see any common themes in these situations?"</p> <p>"When are you making your decision to purchase? Is it before or after you have sat in the driver's seat?"</p>

Endowment Effect: Warning Signs

- Frequently refer to the value of items one owns.
- Losing investments are held onto not because they are part of an investment strategy but primarily because the client owns them.
- Have trouble trying something without the desire to buy it.

Mental accounting

- The process whereby people code, categorize and evaluate economic outcomes, which in turn affects their consumption decisions and other behaviors.
 - People separate their money into separate accounts based on a variety of subjective criteria, such as the source of the money and intent for each account.



Principle	Mental Accounting
Explanation	Valuing some dollars less than others and more readily wasting them; separating money into accounts based on a variety of subjective criteria such as source, storage and purpose.
Counseling Example #1	"I found this great sale – a one-day only thing -- on a high quality flat screen TV. I could afford it by charging it on my credit card and plan to pay it off over the next year or so. My dorm roommates think I rock."
Possible Response	"Tell me, how are the dollars saved on the TV different from the dollars spent to pay the interest on the purchase?" "In the past, how has charging something you wanted worked out in the end?"

Principle	Mental Accounting
Counseling Example #2	"Financially there are good things going on and bad." "I have been saving for spring break for months! I am so excited that I can get a break from school with enough money to show myself a good time." "But the bad thing is my car now needs new tires and I have no clue where to get the cash. I suppose I will have to finance the tires."
Possible Response	Sometimes it is difficult to see resources which we have access to when we have a specific purpose for that resource. Can you inventory for me what money you have saved and what that money is saved for?

Principle	Mental Accounting
Counseling Example #3	"Hey doc, I got a great deal on a new bicycle! One bike I considered was \$799 and the other \$849 with a rebate (\$50 gift card). This was a great deal, I saved \$50!"
Possible Response	"Can you describe exactly how you saved \$50 on that purchase?"

Mental Accounting: Warning Signs

- Do not see themselves as reckless spenders, but have trouble saving.
- Have savings in the bank and revolve balances on credit cards.
- More likely to splurge with a tax refund than with savings.
- Spend more when using credit cards than when using cash.
- Retirement savings are in fixed-income or other conservative investments.

Decision Paralysis

- "Decision paralysis" – making the idea of proactive decisions daunting and uncomfortable
 - The more choices, the more likely individuals will do nothing. Choices are enhanced or hindered by the trade-offs between options.
 - Freedom of choice raises its own discomforts and difficulties.
 - The more time available to complete a task, the less pressure to get it done. Thus the task is never completed.
 - Individuals are likely to choose an option if it is an intermediate choice within a group, rather than at one extreme end.
 - Predisposition to the familiar

I know what I need to do!
Why can't I do it?



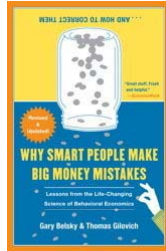
Principle	Decision Paralysis
Explanation	Having a preference for the status quo; avoiding making changes; making proactive decisions; or afraid to make a mistake
Counseling Example #1	<p>“Dr. Davis, I have a \$2,000 loan check I just learned about. I have never even thought about having that much cash at once to spend on anything I want. Can you help me work out a plan as to how to allocate the loan money on necessary expenses.”</p> <p><i>Specific plan agreed to is to pay monthly rent for the semester with the funds.</i></p> <p>“Dr. Davis, I still have not done anything with my \$2,000 of loan money. I just can't part with that much cash. I have been working extra hours to cover rent and now my grades are slipping.”</p>
Possible Response	“Can you describe how you feel about having the cash on hand? Describe how you feel physically when you think of the money? How does your body react when you think of the money?”

Principle	Decision Paralysis
Counseling Example #2	"My car is breaking me! It is ten years old with 250,000 miles and I have spent \$2,000 on it in the last six months. The mechanic has identified another \$2,000 in repairs. I think I need a new car. My parents have offered to help me pay for a used car, I am just afraid to pull the trigger. I have already put so much into this old clunker."
Possible Response	"Really it sounds like you have made up your mind: You need and can afford a used car. Have your parents helped you out with other large purchases in the past, and how has that worked out?"

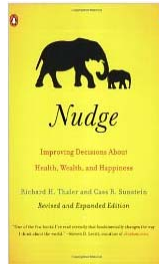
Decision Paralysis: Warning Signs

- Hard time choosing among options when purchasing
- Tend to beat yourself up when your decisions turn out poorly
- Frequently buy things that offer "trial periods" but infrequently take advantage of the return or cancellation policy
- Delay in making investment or spending decisions

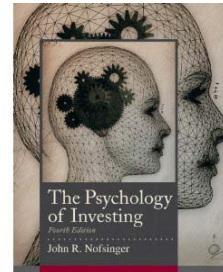
Reference to this presentation and interesting reading...



Gary Belsky
Thomas Gilovich



Richard H. Thaler
Cass R. Sunstein



John R. Nofsinger