Spring May, 2009

The Psychology of Money: Beyond Behavioral Finance

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Exclusive to IMCA, May 2009

Investments & Wealth MONITOR

IMCA®
investment management consultants association

The Psychology of Money: Beyond Behavioral Finance

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Twenty-five years ago, a group of innovative psychologists turned conventional thinking about market behaviors upside down. The resulting body of knowledge fuses economics and psychology and has, since then, become broadly known as behavioral finance. Simply put, behavioral finance holds that emotions and cognitive errors influence investors and their decision-making processes.

What was radical in the 80s now has become more widely accepted by many in the financial planning profession. Perhaps this is because so many of us have experienced first-hand, through our work with clients, what Peter L. Bernstein (1996) called "repeated patterns of irrationality, inconsistency, and incompetence in the way human beings arrive at decisions and choices when faced with uncertainty."

Yet while we recognize how deeply the psychology of money impacts our clients, professional practitioners still are learning how to pragmatically apply the concepts associated with behavioral finance to our day-to-day work. In this article, we take a deeper look at three (of many) straightforward and practical ways that advisors can go a step further and draw upon key tenets of behavioral finance to help clients attain their financial objectives.

Become a Re-Orienter

First, we can employ concepts rooted in behavioral finance to provide clients with a fresh frame of reference for how they think about money.

Clients come to us for investment advice, not to be analyzed. Many view money as something "outside" of themselves and give little prior thought to the psychological, physiological, and emotional aspects of saving, investing, and financial decision-making. But the reality is that we all carry within us decades of internalized patterns of behavior regarding money. By probing these emotional ties—especially the unhealthy or destructive ones—we can re-orient clients' thinking and offer them a different, more healthful framework for dealing with money.

In practice, re-orientation often first entails offering evidence about how the brain works so that clients are more receptive. Most people, for instance, are surprised to learn that 80 percent of all decisions are made by the emotional side of the brain. Then, by using questionnaires and exercises, we can build self-awareness of, for example, belief systems adopted through past experiences by exploring answers to questions such as "How did your parents spend money?" or "How do you use money to reward or punish yourself?" It is almost always an eye-opening experience that helps clients better understand their relationship with money and then, through this discovery, recognize how that relationship may need to change for them to achieve their financial goals.

Is re-orientation always possible? Certainly not. We cannot always help clients make better decisions even when we provide them with all the evidence about why they have a certain relationship with money and what they may need to do to change that relationship. But in the majority of situations, awareness followed by insight does lead to a new perspective, which in turn can lead to a much more rational relationship with money.

Become an Architect of Choice

Secondly, we can give clients gentle pushes in the right direction toward accomplishing their plans.

In their book *Nudge: Improving Decisions About Health, Wealth, and Happiness*, Richard H. Thaler and Cass R. Sunstein (2008) serve up a term we love: "architect of choice." This is an advisor who offers options that do not compromise free will but do help individuals make better decisions about their own well-being by "nudging them"—in other words, giving them a gentle push in the right direction.

Examples include 401(k) programs with automatic enrollment (which the authors call a "default outcome") that result in more participation than opt-in programs. Or cafeteria counters that are arranged in such a way that diners are encouraged to select more healthful foods. In our view, utilizing "nudges" by either inserting defaults into our planning processes or by laying out choices in an easier-to-understand manner are sensible ways to help clients make better choices and achieve better outcomes.

How do we put this into practice? Let us illustrate with a situation undoubtedly familiar to all of us—the overspender. Telling someone that they are overspending will not necessarily stop them from overspending. Instead, we can "nudge" them toward adopting better behaviors by helping them visualize the results of overspending and offering those results up as choices. This may involve painting a picture of scenarios A, B, and C on a continuum of best-to-worst over time. Scenario A may entail, for instance, having to work only five years longer to pay off debt and retire whereas scenario C, at the other end of the scale, may offer an image where the client works for another 10 years and still is unable to retire. What about scenario B? By weaving such a story through visualization, clients not only get a picture in their minds but many also actually experience the emotions associated with each scenario, which can range from pleasant to unpleasant. Using this process, we offer choices to the client, as opposed to only numbers on a spreadsheet. Defaults can be built in and can be as simple as increasing direct payroll deposits to maximize a client's 401(k) contribution.

The architect of choice concept has been critiqued by some as too paternalistic. But the reality is that our clients pay us to be their choice architects. We encourage them to exercise their free will and always underscore the fact that they are ultimately responsible for themselves. By presenting optimal choices first, arranging the array of decisions to be made in descending order and setting up defaults we can better propel them to take actions that they otherwise may have procrastinated about or entirely avoided. That certainly fits our mission, as financial advisors, to work in the client's best interest.

Re-orientation Helps to Ready Couple for Retirement

A couple came to our practice to discuss their retirement plan. During the initial interview, we learned that the husband had invested all of the couple's money in certificates of deposits (CDs). CDs were, in fact, their one and only investment.

Through the interview process, it became clear that the husband's "money script" of extreme risk aversion was written decades ago when his parents lost everything in the Great Depression. The husband was a textbook example of what Daniel Kahneman and the late Amos Tversky (both pioneers in behavioral finance) named "prospect theory." It holds that individuals are more upset by prospective losses than they are made happy by equivalent gains. This phenomenon is adaptive because we are "hardwired" to avoid potentially dangerous situations.

Once the couple recognized how this childhood experience had commandeered their finances, they were able to re-orient and reconcile his emotions and work on making their retirement a reality.

Become a Practitioner of Process

A third way we can apply principles from behavioral finance to our work is to help clients learn and utilize better decision-making processes.

Most of our daily decisions are reactive. We decide, for example, what brand of cereal to buy in a mere split second. In fact, our brains are so adept at making reactive decisions thousands of times each day that we often are not conscious of them. We also are prewired for "flight or fight" decisions—as illustrated by a client so stressed out by the latest stock market loss reports that she decided, in a knee-jerk reaction, to immediately sell all shares. Decision-making at this level, while it may have served our ancestors well in fleeing predators, clearly is not well-suited for making decisions about one's long-term financial future.

Experts in behavioral finance, most notably Daniel Kahneman, who won a Nobel Memorial Price in Economics for his work on how people make decisions when the alternatives involve risk, hold that complex decision-making is best done by the cognitive, reflective part of the brain. Scholars also have indentified many fascinating fallacies (too many to detail here) that trap us into making bad decisions. These include the following:

- anchoring, the tendency to rely too heavily or anchor on one piece of information when making decisions, and
- status quo bias, which shows that people do not change unless there is a perceived incentive to do so.

This can be beneficial in many situations, but one particular client situation offers a compelling illustration. In this instance, a couple with a sizable estate had made ad hoc changes to their estate plan over many years as children were born, businesses and properties were bought and sold, and wealth was accumulated. The result was not an estate plan but a disjointed conglomeration of legal documents with no underlying rationale. Revising the document was perceived to be such a gargantuan task that it remained on the "to-do" list year after year. By providing the couple with an outline for decision-making that started by asking them to list and agree upon their mutual over-arching values, this tangle of documents was sorted out and, after review by an attorney, consolidated into a viable and cohesive estate plan that reflected the couple's wishes. The process used to develop this cohesive estate plan triggered the cognitive part of the brain rather than the reactive part of the brain.

Conclusion

This article has just skimmed the surface of a few of the ways financial advisors can go beyond behavioral finance theory and sensibly put theory into practice in our everyday work. As early adopters, we have, quite happily, seen that this body of knowledge is constantly being upgraded: More academic programs for advisors are starting to incorporate behavioral finance theory into curriculum and more financial planners are actively collaborating with mental health practitioners with specialization and training in behavioral finance. Personally, many of us also have found ways to introduce the techniques we practice with clients into our own lives in order to stay centered and calm in the midst of the very difficult and demanding professional environment of the past several months.

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Published by Investment Management Consultants Association
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