Behavioral Finance Biases

Behavioral finance examines how psychological factors influence financial decisions. Human desires, goals, and motivations are rooted in psychology, which also underpins numerous errors in judgement. These errors can arise from perceptual illusions, overconfidence, over-reliance on heuristics, and emotional reactions. Here are some examples:

Financial Infidelity

Financial infidelity occurs when one partner lies about debts, credit cards, or secret accounts, and hides purchases from the other. Signs include unexplained withdrawals, expensive purchases, and unfamiliar statements. Couples should develop a money strategy that suits them, whether it involves combining accounts or having separate ones.

Anchoring

Anchoring is when investors fixate on a specific price as the fair value of a stock. For example, if you bought a stock at $100 and it drops to $50, you might hold on, believing its "real" value is $100. However, the stock's actual value depends on fundamentals and comparable investments, not its past price when you bought it. The drop to $50 could reflect new negative information about the company.

Attachment Bias

Attachment bias involves holding onto an investment for emotional reasons rather than practical ones. For example, keeping a stock because it was inherited from a loved one, such as a grandfather, and feeling unable to sell it because it belonged to him.

Financial Enmeshment

Financial enmeshment occurs when parents and children's finances are improperly mixed, often due to factors like college costs, job markets, and housing expenses. This can result in children lacking financial motivation and lowered confidence. It also includes involving children in adult financial conversations before they are ready, potentially harming their development.

Confirmation Bias

Confirmation bias is the tendency to accept information that confirms our beliefs and ignore information that contradicts them. For example, an investor intrigued by a hot stock might focus on positive aspects like low debt-to-equity and good reviews on Reddit, while ignoring negative factors like a dwindling market or guidance from an experienced financial advisor.

Diversification Errors

Investors often diversify evenly across available options, leading to misguided diversification. For example, 401K participants who are provided a couple dozen fund options within their plan and elect to spread money across all of these options without considering actual diversification needs.

Fear of Regret

Fear of regret is the tendency to avoid action to prevent potential mistakes. For example, an investor may hold onto a losing stock for a long time to avoid the potential regret from selling it and then watching it rebound.

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Herd Behavior

Herd behavior is the tendency to mimic the actions of a larger group, often driven by Fear of Missing Out (FOMO). For example, in the late 1990s, investors poured money into internet companies, leading to overvalued investments that suffered significant losses.

Hindsight Bias

Hindsight bias is the tendency to believe we understood an event's outcome after it has happened, leading to overconfidence. For example, many claim they saw the tech bubble coming in the 1990s, even though they didn't recognize the signs at the time.

Analysis Paralysis

Analysis paralysis occurs when overanalyzing a situation prevents decision-making, often due to fear of making a mistake or finding a perfect solution. This can lead to inaction, as individuals or couples are overwhelmed by options and the complexity of the decision. For example, someone may endlessly analyze investment strategies, and then leave their money in cash.

Loss Aversion

Loss aversion describes how investors feel the pain of losses much more intensely than the pleasure of gains. This bias often leads them to hold onto losing investments and avoid reassessing their choices rationally. For example, an investor might sell a successful investment too early to lock in gains while holding onto a losing one, hoping it will rebound.

Mental Accounting

Mental accounting involves treating money differently based on its source or intended use. For example, an employee might invest employer contributions in risky assets while keeping personal contributions safe, viewing the employer's money as less valuable. This can lead to inefficient financial decisions, such as saving in low-interest accounts while carrying high-interest debt.

Overconfidence

Overconfidence is the tendency to overestimate one's own abilities, often paired with confirmation bias. For instance, overconfident investors may believe they are exceptional at picking stocks and timing the market. This can lead to risky decisions.

Money Scripts

Money scripts are subconscious beliefs about money formed in childhood, influenced by personal experiences and family or cultural values. The four common types are:

- Money avoidance - *fear or discomfort about money*
- Money worship - *overemphasis on financial success*
- Money vigilance - *careful and cautious with money*
- Money status - *viewing money as a status symbol*

Do you see any that resonate with your beliefs? Recognizing your money script can help assess your relationship with money and lead to better awareness and better financial decisions.