

FPA RETREAT MAY 2013

It's Not Just Their Money It's Their Life!

BEHAVIORAL FINANCE ABBREVIATED
FOR
REALLY SMART PEOPLE
WHO ARE
SHORT ON TIME
AND
BIG ON DELIVERY



OPTIMIZING HUMAN CAPITAL

TERRI FINNEY, PSY.D.

- COACHING
- CONSULTATION
- COLLABORATION

4770 EAST ILIFF STREET, STE. 219

DENVER, CO 80222

303-790-5976

TERRI@DRFINNEY.COM

INTRODUCTION

Financial planning involves lots of decision making. We like to think... want to think... that that we rationally analyze all the factors before making a choice or determining the value at issue. However, the truth is that our choices and decisions are affected by factors of which we are not aware.

Behavioral economics is the study of the effects of social, cognitive, and emotional factors on the economic decisions of individuals and institutions. It is primarily concerned with understanding the differences between what is rational, and what we actually decide or choose.

Daniel Kahneman's book (2011) *Thinking Fast and Slow* is one of the most often referenced books about systematic errors in decision making. At the most basic level, Kahneman believes that most of our biases are based on the fact that we assume a coherent, complete picture, even though we have incomplete information. We make decisions automatically or quickly with little or no effort.

AFFECTIVE FORECASTING

It turns out we're not very good at predicting our future happiness. Three main sources of problems in our decision making process: cognitive biases, mental simulation, and psychosocial factors of which we aren't aware.

Cognitive Biases

Loss Aversion: We tend to strongly prefer avoiding loss to acquiring gains. So a \$100 loss will be experienced more intensely than acquiring a \$100 windfall. There are studies that suggest that losses are twice as powerful psychologically as gains.

Framing (similar to loss aversion): People react differently depending on whether something is framed positively or negatively. Automatic savings occurs more often if one has to opt out than if one has to opt in.

Impact bias: We tend to overestimate the intensity and duration of emotions in reaction to positive and negative events. The elation of a big win for the favorite football team is less intense than we predict.

Immune neglect bias: People don't appreciate the ability of their psychological immune system to help recuperate from negative effects. (Psychological immune system becomes activated when there is no other way out.) Bad outcomes (such as depleting savings or losing a major portion of their IRA due to stock market decline) don't affect people as profoundly as they might expect.

Negativity bias: We are more sensitive to negative events than positive.

Status quo bias: An irrational preference for the current state of affairs. We tend to prioritize avoiding the feeling of regret. We might fixate on the potential regret for ourselves or our heirs if we make a decision involving change that one day appears to have been wrong.

MORE AFFECTIVE FORECASTING PROBLEMS

Mental Simulation

Mental simulation is the anticipation, explanation, or imagining process that we go through to help us make decisions. They are likely to be negatively skewed leading to early retirement.

Under Representative

We remember most positive or most negative experiences versus instances that average.

Essentialized

We focus on only the main features of an event but not minor details. Ideally our overall experience it takes into account major and minor factors that are both positive and negative. Essentialized simulations of retirement might focus only on the major aspects of leaving the workforce versus smaller details

Abbreviated View

We see things in the short term only. The early stages of retirement are the most positive.

Decontextualized

Contextual factors that are present at the time of the simulation may not be present at the time the event occurs.

CREATING A DECISION-MAKING ENVIRONMENT

You can help your client by helping them broaden their frame of reference.

In terms of process:

1. Let them set the agenda and the pace. Follow their lead. This may take longer (in terms of sessions) than you expect.
2. Approach from a partner stance, not an expert stance. They are the experts on themselves.
3. Approach with Beginners Mind. Set aside your expectations and assumptions about how they are going to do retirement.
4. Listen with an awareness of behavioral tendencies.
5. Be more vigilant about how choices are framed or presented.
6. Be patient.
7. If you ignore their need to process emotions and push ahead with your agenda, your meeting is unlikely to be successful.
8. Invite and suggest. Don't coerce.

Specific questions that broaden and deepen the field of information and emotional expression:

1. "I'm curious about that. Can you tell me more?"
2. "That's interesting. How did you come to that decision?"
3. "How are your friends dealing with retirement?"
4. "What is your biggest fear?"
5. "What are you most excited about?"
6. "I'm wondering if you have thought about XXX?"

Give them homework.

Send them home with a list of things to get specific about. You may need to follow up and coach them toward working on this.

1. Create a daily schedule for themselves.
2. Identify their new friends or support system.
3. Identify special interests they haven't had time to pursue and now will.
4. What are their social or networking opportunities?
5. How are they going to derive PURPOSE in their new life?
6. What is their plan to stay physically active?

GOOD READING (for advisors)

Your Money and Your Brain by Jason Zweig

Predictably Irrational by Dan Ariely

Thinking Fast and Slow by Daniel Kahneman

Sway by Ori Brafman and Rom Brafman

Tipping Point by Malcolm Gladwell

Blink by Malcolm Gladwell

Practical Wisdom by Barry Schwartz and Kenneth Sharpe

The Paradox of Choice by Barry Schwartz

Predictably Irrational by Dan Ariel