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## *FLASH REPORT*

# YOUR MIND WANTS YOU TO MAKE MENTAL MONEY MISTAKES

Behavioral finance—the study of people’s biases about money and investing, and how those biases impact decision making—has become a hot topic. A pioneer in the field even was awarded the Nobel Memorial Prize in Economic Sciences for his work a few years ago.

Understanding some key aspects of behavioral finance can potentially help you make smarter decisions in multiple areas of your financial life. By getting a handle on behavioral biases and how they influence our thinking—as well as developing some strategies to combat them—we can potentially hit “pause” or “stop” before we make errors that could prove to be costly.

### SOME COMMON MENTAL MONEY MISTAKES

Our brains are essentially hardwired to take mental shortcuts in all kinds of situations so we can reach conclusions, make decisions and take action quickly. That’s not necessarily bad. But it can spell trouble when evaluating situations involving our cash or investment capital and managing our emotions. Specifically, shortcuts can lead us to commit these types (among many others) of behavioral finance errors:

1. **Anchoring.** This involves making decisions based on a particular starting point, or anchor. A typical example is when the price of a car or other big-ticket item is significantly reduced from its original asking price. Our brains want to judge the current price based on how much less it is than the original price. The problem occurs when that original price is irrational in the first place. With investing, anchoring can cause us to hold on to bad investments that have declined precipitously from the price at which we bought them—hoping that they’ll return to their original, “real” value levels.
2. **Loss aversion.** This concept reflects the brain’s preference to avoid a loss rather than realize an equivalent gain—or, simply put, we’d rather avoid losing \$100 than gain \$100. Fear of loss can be a major driver of investing assets so conservatively that it becomes challenging (even impossible) to achieve one’s long-term financial goals. Ultimately, loss aversion can cause investors to think about risk in a skewed manner that doesn’t necessarily address bigger risks to their financial future than short-term losses.
3. **Hindsight bias.** This is our tendency to look back at an event whose outcome was uncertain and believe that outcome was easily predictable and obvious. This bias causes people to selectively ignore the various possible results they once considered and convince themselves that the actual outcome was the one they knew would come to pass. Ultimately, this can lead people to overestimate their judgment and decision-making abilities going forward—becoming overconfident in their ability to, for example, pick winning investments.

## TIPS FOR AVOIDING COSTLY ERRORS

Simply knowing how our brains can work against us and hinder our ability to make sound financial decisions is helpful information. But the key is to go beyond knowing about the problem and figure out what to do about it. Consider these actions and ideas that could potentially help you.

- **Examine alignment.** How well does an investment you're considering match up with your overall objectives? For example, it's extremely easy to get attracted to a red-hot stock, group of stocks or market sector. If your investment goals are to pursue the highest possible returns regardless of the risk, the investment could align with your approach. If, however, you are concerned with downside volatility and protecting wealth, you may find it appropriate to pass on that "opportunity" by reminding yourself why you're investing in the first place.
- **Practice gratitude.** Combating behavioral biases often requires "rewiring" your brain. If you focus each day on specific things you're grateful for and the good things you already have in your life, your brain (over time) can start to become less fearful of possible losses. When your brain starts scanning for the good things around you at least as much as it does for the threats, you can make decisions about money (and many other things) from a perspective of abundance rather than scarcity.
- **Shut down catastrophic thinking.** Loss aversion is often driven by our brains imagining the worst possible outcomes of our bad decisions—also known as catastrophic thinking. And while, yes, the most horrible result could come to be if we make a mistake, the likelihood of that result coming to be may be extremely low. Therefore, think critically about just how likely a catastrophic outcome might be—as well as the probability of other outcomes occurring that are only mildly bad or even (gasp!) positive.
- **Gather more information than you think you need.** Anchoring often happens when we have limited amounts of information or we focus too much on one piece of data. To help combat this bias, gather as much relevant information as you can to develop a fuller, clearer picture.
- **Look for views that challenge your own.** Just as important as gathering lots of high-quality information is seeking out information from a variety of sources with multiple opinions—including opinions that may differ from your own and that challenge your assumptions. Anchoring yourself exclusively to viewpoints that confirm your existing beliefs or hopes can blind you to risks and other important considerations that should be factored into your decision making.
- **Track and revisit your investment decisions over time.** Hindsight bias can stop us from learning important lessons from the errors we've made in the past. To fight it, keep a log or journal of your investments that includes what you buy and why, and your expectations for the asset. Over time, compare the actual outcomes with your initial reasoning and predictions.

Perhaps most important, when an "opportunity" or a "risk" comes across your radar screen, slow down. Take a breath. The "caveman" part of our brain wants us to take action right away. Do your best to not let it override your good sense.

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