Abracadabra: The Magic Workings of the Brain

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Did you ever wonder why, at times, everyone makes decisions that don't seem logical? Research in the relatively new fields of behavioral economics and neurofinance can help us understand why we all make those decisions. Researchers have discovered patterns of cognitive illusions, biases, and intuition that result in irrational decisions. Behavioral economics uses observations and neurofinance uses brain imaging to track, confirm and even predict behavior patterns. Their findings provide useful insights into the subconscious workings of the brain when money is involved. The following are examples of some of the common patterns they've identified. Each has a definition, example and an action financial advisers can take to avoid, minimize or be aware of these subconscious patterns. (The number indicates the reference where you will find more information.)

Confirmation Bias12

Definition: When one can only hear the facts that agree with their beliefs and is literally deaf and blind to any conflicting information. **Example:** Daniel's company is rumored to be closing. He ignored all the concrete signs that they were going bankrupt and listened to Uncle Joe who said this company is solid and will be rescued. Without any evidence to support his beliefs, Daniel is confident his job is okay in spite of his hours being cut back. He continues to purchase items and spend money as if there was no risk about his financial future. Now he comes in for help getting a loan for a new truck. **Action**: Don't try to argue factual points. Approach it from an emotional position by listening to the story about what this truck means to him. Then ask: Would you recommend that your friend (mother, brother) take out a new loan for a truck now if they worked for your company? What would you tell them?

Unconscious bias (or Implicit Egoism) 9 & 11

Definition: We subconsciously identify with people, places and things that resemble ourselves. **Example:** When giving advice to stretch and invest in education to have a better shot at better jobs, without realizing it the advisor may recommend learning a trade to one group of students and encourage another group to get a college education. **Action**: Review your interactions over the past year and consider if there are any unusual personal identity patterns. Consider your favorite and least favorite clients/students to see if you can discover any patterns related to personal similarities and how that correlates with the amount of effort and/or attention you give them. Think about the person you usually speak to in a couple. Is there a pattern?

Familiarity (8)

Definition: Investors are more likely to choose investments that have familiar names that are appealing. **Example**; A group of Australian managers are asked to recommend one of two mutual funds, one of which is managed by William R. Taylor; the other by Vishakh Tyrewala. Although their performance is identical, a fairly reliable prediction would be that the number of managers who choose the fund run by William R. Taylor will exceed those who choose the other fund by about 15%. Investors are also more likely to pick stocks that have familiar ticker symbols, especially if they find them amusing like HOG (Harley Davidson), MOO (Market Vectors Agribusiness ETF), and FIZZ (National Beverage). **Action**: Review your portfolio and those of your clients to see if there are any unexpected patterns.

Disposition Effect or Status-Quo Bias (19)

Definition: People will subconsciously do whatever it takes to return to the self-image they are comfortable with. **Examples**: Andrew thinks of himself as smart and confident, but he made a bad investment by giving money to his friend to start a bogus business and he feels stupid. As a result, he will do whatever it takes to get rid of the mistake, even hiding the evidence if possible, then pretending nothing happened so he can resurrect his self-image as competent and smart. If asked about the money, it's likely he will find someone else to blame in order to protect his self-image. Conversely, Sarah thinks of herself as having less than others and needing to struggle to make ends meet. She lives very frugally and saves and invests as much of her money as possible. Her savings have added up and her investments did well. When she realized she was on her way to becoming so financially secure she could afford to buy a nicer house and treat herself to a more comfortable lifestyle it made her completely uncomfortable. She didn't want to be one of "those rich people". She began gifting a lot of money to a TV church which sabotaged her long range plan but returned her closer to the status with which she identified. **Action**: Provide opportunities that encourage people to talk and share their stories. How did they see themselves as children—poor or wealthy? Who do they know that is financially successful? What do they think of that person? What would change in their relationships with family and friends if their financial status changed? Their answers will give you insights into how they will react to financial success or failure. Don't assume that more money and financial security is everyone's emotional financial goal.

Preference Reversal (19)
Definition: When evaluating long-term financial options, people will predictably choose the bigger, better reward. However, when weighing short-term choices, they will typically opt for the smaller, lesser reward for quicker gratification. **Example**: Ben chose to increase his savings now so he could retire at 50, but then when buying a house, he spent much more than he planned to which meant there was less to put into the early retirement plan. **Action:** Once a plan is in place, set up automatic deductions from earnings to savings and when possible, have a plan to save or invest all or a fixed percent of "new" money (a raise, bonus, inheritance, winnings, etc.) that has not been spoken for yet so it is will not feel like a loss. Talk about the types of temptations that will come up that could sabotage the plan and strategize how you can help clients stay on track.

Mixed-Messages (15)
Definition: Although people will say how much risk they can tolerate, their choices do not necessarily reflect what they say. Brain scans showing the part of the brain that lights up when a risky purchase is being considered can more accurately predict what a person will do more than a self-assessment. **Example:** Kate has told you she is comfortable with taking financial risks, but when her brain scan indicates purchasing a house is risky, it elicits a response indicating fear—and is reliably predicts that she will not save for and then purchase the house. **Action:** Avoid asking direct questions and using questionnaires to assess risk. These rely on logical thinking and the answers will reflect what they want to believe. Instead, provide opportunities for your clients to relate their stories and actively listen to learn more about where financial risk was involved or avoided. Risk-takers in one area of life may not generalize to being financial risk-takers. You cannot generalize that someone who is sexually promiscuous or races motorcycles will take risks with his/her money.

Illusion of Control (14)
Definition: When individuals believe that they can predict the odds to accurately place bets even though they have no control or influence on the game. **Example**: Emma buys and sells erratically. She has a strong reaction and blames herself or feels guilty when she loses money because she missed an opportunity or mistimed buying or selling. **Action:** See Ulysses Contract below.

Gambler's fallacy (5)
Definition: The erroneous belief that a past pattern influences future odds. If you toss a coin and it turns up heads five times, the odds still are 50-50 on successive tries, even though it might appear that the odds for heads should go down. **Example:** Rebecca believes that because a stock or fund has declined significantly, it's bound to go up and invests as if that were true. **Action:** See Ulysses Contract below.

Dopamine Effect (10)
Definition: Dopamine is a complex brain chemical that is associated with success. It tells us what feels good, what is important and what to pay attention to. It is associated with getting a reward and/or anticipating a reward and moving toward achieving it. Highly pleasurable or intense experiences trigger the release of a lot of dopamine which creates a lasting memory of that experience and can cause craving those intense experiences and needing them repeatedly. Taken to excess, that craving can be linked to overconfidence and addictions like gambling. **Example**. Matt experienced a couple of great stock picks. They were highly pleasurable, intense events with a dopamine rush. Now he craves that high and is focused on recreating that feeling. Just anticipating it causes an increase in dopamine and he is driven to take wild, irrational risks with his money. He rationalizes his actions by pointing to his big profits which justifies continuing to apply his winning strategy. **Action:** See Ulysses Contract.

Serotonin Effect (13 & 16)
Definition: This complex brain chemical is associated with coping with adversity and helps people stay in control and keep going while trying to sort everything out. It helps people manage the bumps along the way and be able to delay gratification knowing there will be a reward in the future. Disturbances of serotonin levels can lead to panic attacks and rash behavior. Serotonin levels can be used to predict risk-taking behavior. **Example**: Michelle had a great plan that she said she was committed to, but her advisor could predict when Michelle would be calling in a panic wanting to sell her stocks. **Action:** Empower clients. Give them simple steps to assess a situation. Feeling more confident and in control can help stabilize serotonin levels and reduce panic or other extreme reactions. See Ulysses Contract.

Ulysses Contract (1)
This is a contract between adviser and client. The clients pre-commit to a plan for buying and selling so they cannot sabotage their plans by reacting emotionally to events or others' influence as the market has its ups and downs.

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