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Waymark financial

In collaboration with
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Behavioural biases: How they impact your financial decisions

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Neil Bage is the founder of behavioural insight's fintech company Be-IQ and a specialist on the sub-conscious behaviours that drive our decisions. He is renowned for bridging complex scientific theory with real-world understanding and application.

Neil has presented to thousands of business professionals around the world on human evolution, psychology, and human biology, all of which combine to reveal how people make important decisions that will impact their wellbeing.

"I help people understand what's going on inside their head when they are making decisions, particularly those that will impact their financial health and wellbeing."

Every day we make thousands of decisions. Some are small and unimportant, such as would you like a ginger snap biscuit with your morning coffee or a custard cream?

However, some of the decisions we need to make are important and can have a long-lasting impact on us if they don't turn out as we hope.

Financial decisions fall firmly into the latter category; important decisions that can have a long-lasting impact on us if we get them wrong. And yet, making important financial decisions isn't that easy.

To start with, money is a very emotional subject. It triggers certain feelings in us that can have an impact on the decisions we make. The way our brain has evolved over the past 3.5 million years also has an impact. It sees us processing information in a fast-paced 21st-century world, in a way that can lead to us thinking we're being thorough, but actually, we take dozens of unconscious short-cuts to reach a decision to get it off our plate.

These unconscious short-cuts or 'rules of thumb' that we take, are known by psychologists as heuristics. They are the starting place for understanding how we make decisions.

Heuristics [hyoo-ris-tiks]

Every day we make decisions. In some cases, we give these slow, deliberate thought. But most of the time, we need to make a quick decision, and this is where heuristics come in to play.

Now, it's important to note that heuristics aren't about making the perfect decision. They are about making a quick decision with as little effort as possible. There are several heuristics that every human uses but the following three examples impact most of the decisions we make.

Definition: Heuristics

'Rules of thumb' we've developed over time; mental tools to help us make quick decisions.

1. Availability heuristic

The availability heuristic is one of the most powerful shortcuts we use in decision making.

In essence, when we need to make a decision, we have to get past the first thing that pops into our mind.

If you think of this question: "do you think flying is safe?" you'll find it hard to not think of the odd plane crash instead of the millions that land safely. That is because we have a natural tendency to focus on vivid or negative messages or focus on something we've recently seen or experienced that ends up dominating our thoughts.

2. Representativeness heuristic

The representativeness heuristic is used to decide whether a person, an event or a thing should be put into a certain category (safe, dangerous, friendly, nasty) by comparing it to what we believe is typical.

In other words, a chair may have four legs, a seating part, and some sort of back support. If we see something that looks like a chair, then we will automatically, without even thinking about it, place it in the unconscious category of 'chair'.

Unfortunately, we do this with people all the time. We look at certain characteristics of a person, and put them, almost without question, into a category - nice, friendly, unfriendly, smart, stupid - before we even get to know the person. Even though we are all taught to never judge a book by its cover, most of us go through life incorrectly judging lots of books by their cover, and it's down to the power of this heuristic.

3. Affect heuristic

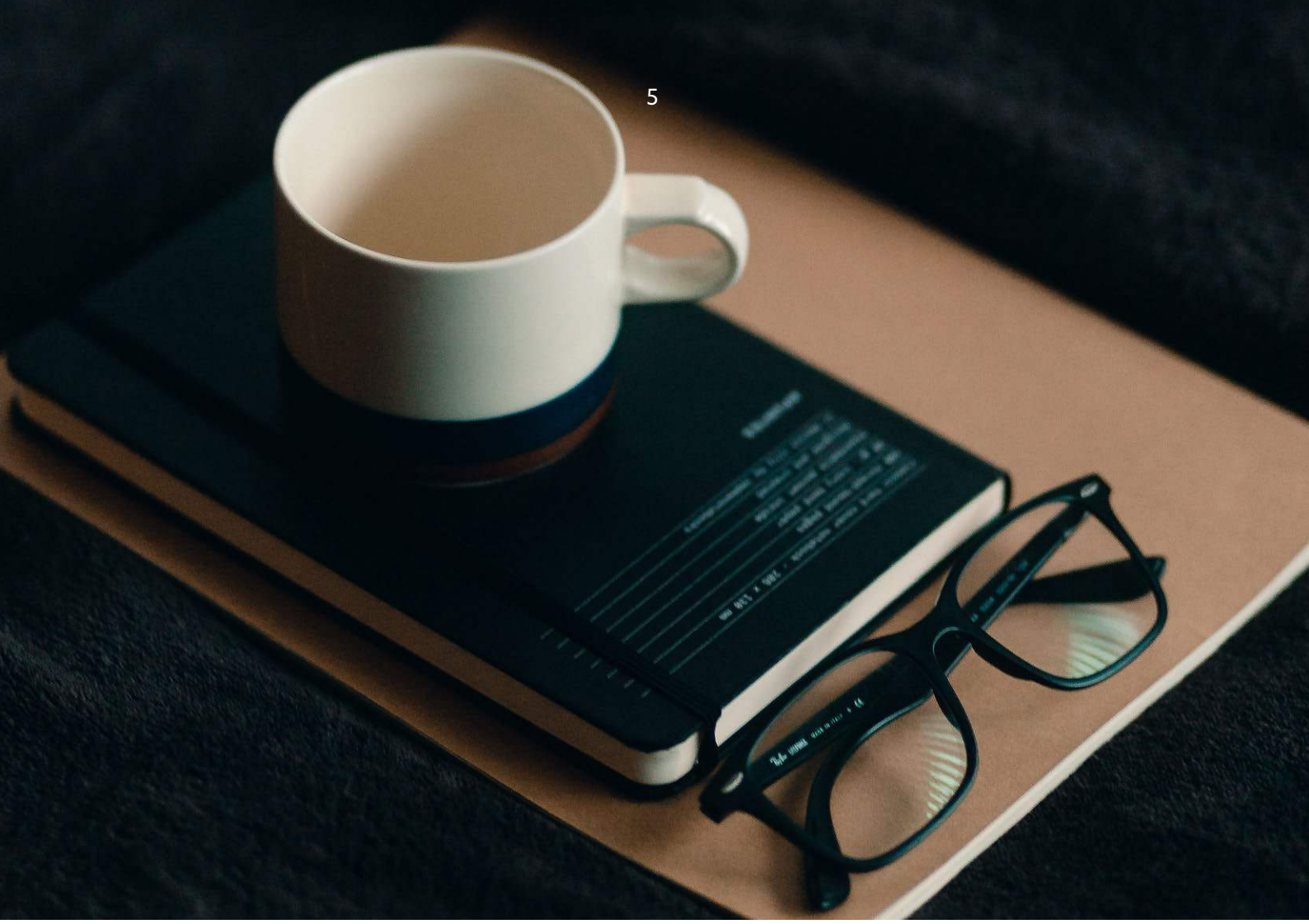
The affect heuristic sees us making decisions that are heavily influenced by our current emotional state, such as fear, pleasure or surprise.

Like the other two heuristics, this is a shortcut that reduces the decision-making process and allows us to function without having to complete extensive research. The affect heuristic is often used when we need to make a decision involving risk versus reward or exploring the benefits of something.

In other words, the affect heuristic is pretty much 'going with your gut'. If our feelings towards something are positive, then we are more likely to judge the risks as low and the benefits high. On the other hand, if we're feeling negative towards something, we are more likely to perceive the risks as high and benefits low.

If by using these rules-of-thumb we still don't reach a satisfactory decision, we will apply our own filters to the information we need to use to reach a decision as quickly as we can.

These filters are, in essence, our behavioural biases. They are based on our values, principles, experiences, and general views and opinions. The power of them in the decision-making process should never be underestimated.



What are behavioural biases?

Behavioural biases can be seen as unconscious filters that impact how our beliefs are formed, how we reason, and how we apply our judgement. Behavioural biases can be categorised into two distinct groups; affective and cognitive.

Affective biases are when we allow our emotions to impact our decisions, whereas cognitive biases are all about errors in processing information.

There is also a constant interplay between the two. Our emotional state can mean that we don't pay full attention to important information. Equally, when we process information, such as reading a document or watching the news, what we see and hear can make us react emotionally. This means that the decisions we end up taking may not lead to the best outcomes.

Behavioural bias can affect your decisions in unexpected ways; there are over 150 recognised behavioural biases.

Definition: Bias

Cause to feel or show inclination or prejudice for or against someone or something.

When we look at the long list of behavioural biases, there are several that are not only very powerful but play a significant role in the financial decisions we make. Here are ten examples of behavioural biases that impact such decisions.

1. Confirmation bias

Known by psychologists as the mother of all behavioural biases, confirmation bias is incredibly powerful.

When you start thinking about a financial decision that needs to be made, there's a chance that you've already formed a preconceived idea about what you want and what is 'right for you'.

For example, you may decide to research whether investing in a specific company is right, but in the back of your mind, you may have already decided it is. Therefore, you only search for information that confirms this belief whilst ignoring the evidence that could prove otherwise.

2. Framing bias

Framing bias is responsible for us making a decision based on how information is presented to us as opposed to the full story.

In other words, when we see a yoghurt is 80% fat-free, we see this as positive. However, we rarely stop to recognise that 80% fat-free also means it contains 20% fat, which is a negative message. This message – 80% fat-free versus 20% fat – is framing in practice.

In other words, the more negatively framed, the more we try and avoid it. Frame something positively, and we are like a moth flying towards a flame.

3. Anchoring bias

Anchoring bias is where we rely too much on existing information or the first piece of information we find when making decisions. We see anchoring being used all over the place, but it really comes into its own on the big sales days, like Black Friday and Cyber Monday.

Turn the TV on and you will see adverts showing reduced price goods, alongside their original price. The new sofa that was £999 is now £359. It seems like a genuine bargain, and it might be, but anchoring impacts our judgement.

We decide that something is a good deal simply based on a reduced price point (the anchor), without considering if we're still getting value for money.

4. Overconfidence

Underpinning many of our behavioural biases is one big, powerful behavioural bias. This bias kind of permits all the other biases to exist. What could be so powerful?

Overconfidence.

Overconfidence is a solid human trait and is present in every one of us to some degree. Some of us are naturally more overconfident than others. Some of us become more overconfident than others at particular times and when doing particular things, like investing money. We need to make decisions in life that will give us the best possible outcome, and keeping our confidence operating at the right level will give us the best chance at making great decisions.

5. Loss aversion

Loss aversion is our natural desire to prefer avoiding a loss to acquiring an equivalent gain. What this basically means is that we *feel* losing £10 more than we would feel *gaining* £10.

So, if you are walking down the street and find a £10 note on the floor - brilliant - of course, you'd feel happy that you've found money. But equally, if you put your hand in your pocket and realise you lost £10, that feeling – the sinking feeling you get in your stomach – is felt more. This is loss aversion being played out.

When it comes to investing, loss aversion is a key behaviour in determining the level of risk we are willing to take with our investments. It can be so dominant that we end up taking very little risk based on nothing more than the fear of losing.

6. Present bias

Present bias is our tendency to place too much value on immediate rewards at the expense of our longer-term plans.

Since it centres around instant gratification – that needing or wanting something now – it impacts lots of our decisions. It's what makes us buy the latest gadget instead of saving the money for a rainy day. It's what makes us eat that doughnut instead of the salad.

Ultimately, our present and future wellbeing are reliant on us having good control of those instant gratification points in life. The more you choose today over tomorrow, the more your long-term wellbeing may suffer; financially, physically, and mentally.

7. Attentional bias

When you are making a really important decision, especially a decision to do with money, do you consider all possibilities and outcomes before you land on the decision? Or do you tend to only focus on a few options, the most dominant options, for example, whilst ignoring others?

If it's the second statement, that's attentional bias at play; focusing your attention on the most dominant messages. We need to be careful when we are making important financial decisions that we aren't being influenced - or more to the point, influenced too strongly - by more dominant messages that are there to catch our attention.

This is often the place when scammers live, pushing out messages that get our attention with promises that are always too good to be true. But if we allow these attention-grabbing messages to influence how we make a decision, then we could end up being at best disappointed, but at worst, in a place where we suffer financially.

8. Herding bias

Herding bias is seen by many experts as one of the most dominant behavioural biases when it comes to investing.

Herding bias is a really interesting phenomenon where people will convince themselves that a course of action is the right one simply because 'everybody else' is doing it. In other words, it's our tendency to mimic the crowd without considering our own judgements.

It's why trends take off. The more people that join in, the harder it is for us to be on the outside looking in, and so, we join in and go along for the ride.

9. Probability neglect

There is a universal truth that underpins the behavioural bias of probability neglect. As humans, we are really bad at assessing risk. We are generally so bad at this, that we assume that common activities we engage in – like driving a car – are safer and less risky than uncommon activities we engage in – like flying in a plane.

It can have an impact on many decisions we make, not least your financial decisions. It can make us think we're safe when we're in danger, and in danger when we're safe. It can stop us doing something that could be valuable and rewarding or make us do things where we end up saying "I'll never do that again!"

10. The illusion of control

There is a very human belief that we have greater control over things than we do. Psychologists call this the illusion of control. It is so powerful in the way we think (and of course linked to overconfidence) that psychologists believe 'control' to be the number one human addiction.

When it comes to money and investing, people believe that if they have control over the investments they chose or the stocks they pick, then the outcome is more likely to be good than if they have no control at all, even if the investment choice is being selected by an investment professional.

What's really interesting here is that if you and an investment professional jointly choose an investment and it went wrong, it would be the professional's fault. If it went well, the success would be down to the choices that you made and not necessarily the professional. This is the illusion of control and such is the power of self-belief.

Investing: Taking too much or too little risk

One of the most researched areas for where behavioural biases have the biggest impact is investing. They can impact not only the planning stage but the investments you chose and the risk you are willing to accept to achieve your ambitions.

Risk can be split into two areas; subjective and objective. Both are important to understand when it comes to risk-based decisions.

Subjective risk is the level of risk we believe we can take. It's not grounded in any fact but is fuelled by all the behavioural biases we have coursing through our brain's synapses.

Objective risk is based on how you actually behave when faced with a risk.

Let's make this simple.

Imagine you are on a skiing holiday and your friend describes a pretty interesting part of the mountain they've been on, and ask if you'd be OK to try it? You say yes, that you're a competent skier, and you're always up for a challenge. However, when you are stood on top of the mountain looking down, reality kicks in, and you may realise that you've bitten off more than you can chew.

This translates to investing. You may think that investing in several start-up companies after hearing from colleagues that they will deliver high returns in the next few years, is right up your street. However, when you put your money in and see their share prices plummeting, the realisation that this wasn't for you kicks in. Remember, the power of behavioural biases, such as loss aversion.

It's important that your investment portfolio remains balanced and diversified while still reflecting your aspirations. Making snap decisions without looking at the bigger picture can lead a portfolio diverging from your wider strategy.

But this doesn't mean that people should shy away from taking investment risk altogether. Sometimes not taking enough risk can be just as impactful on your long-term plans.

It's about understanding what is right for you and your needs. It's about understanding not how you think you'll behave, but how you do behave when faced with risky choices. It's about being honest to yourself and factoring that into your financial plan.

This ensures that the inevitable ups and downs you'll experience should be less stressful, induce less anxiety, and give you the best chance possible of realising your financial objectives.

Can we reduce the impact of behavioural bias?

The answer is a resounding yes. But it involves work on our part.

We need to accept that our subjective view of the world is often at odds with the objective reality. We need to accept that what we think and what we do can be very different. In other words, we need to go on a journey of self-discovery and learn about who we really are, especially in relation to important financial decisions. Some great tips to help you along the way, are:

1. **Pause and ask yourself if your biases are affecting your decisions:** Knowing that biases can unwittingly affect you is the first step to reducing the impact. When making a financial decision, ask yourself what you're basing it on. Sometimes just taking a step back to think is all you need to recognise that your behavioural biases are present.

2. **Understand the role your emotions play:** Emotions naturally have an impact on how we feel about things and, therefore, the decisions we make. Heightened emotions can affect our ability to make decisions. If you're in an emotional state and you need to make a decision, the best advice is always to sleep on it. Give your brain and your emotions time to settle before coming back to the task in hand.

3. **Consider the sources you use for information:** With so much information, it can be difficult to know what to focus on. Our first step here is to understand where information is coming from. Not all sources are equal. Assess how trustworthy they are and the value they deliver.

4. **Don't forget to double-check:** Errors occur when we're processing information, so it's always worth double-checking before you proceed. It's a step that can highlight potential errors and also give you confidence in the action you're taking. Equally, challenge your decision-making. Ask yourself if you've got the full picture, all the evidence, and pull yourself up if you've only got information that supports your current thinking.

5. **Keep in mind that your financial plan is a decade or more long term:** Biases are more likely to occur when we don't take the necessary time when making important decisions. Spending some time researching or thinking about your options shouldn't be seen as a negative thing, it can help put decisions into perspective.

How can we help?

Speaking to a financial planner about your plan can highlight where and when our behavioural biases occur. Having another pair of eyes review the financial decisions you're making can reduce the impact of your biases and ensure the decisions you make are right for you and your aspirations.

As a financial planner, we will work with you to create a long-term plan with your aspirations in mind. We'll explain, without jargon, what your options are and the pros and cons of each, providing you with complete confidence in the actions you take.

It's a step that can reduce the temptation to stray from the plan when behavioural biases do occur. If potential opportunities do arise, we're here to act as a sounding board before you act to keep you on track.

If you'd like to discuss your aspirations and how we can help you achieve them, please get in touch. We'll help you to overcome financial biases and craft a plan that puts your priorities at the centre.

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