Sophia

Your Financial Well-Being

by Sophia

WHAT'S COVERED

In this lesson, you will learn strategies to overcome mental biases and improve financial decision making and well-being. You will better understand how using agility and overcoming these biases can make you more productive. Specifically, this lesson will cover:

1. Procrastination

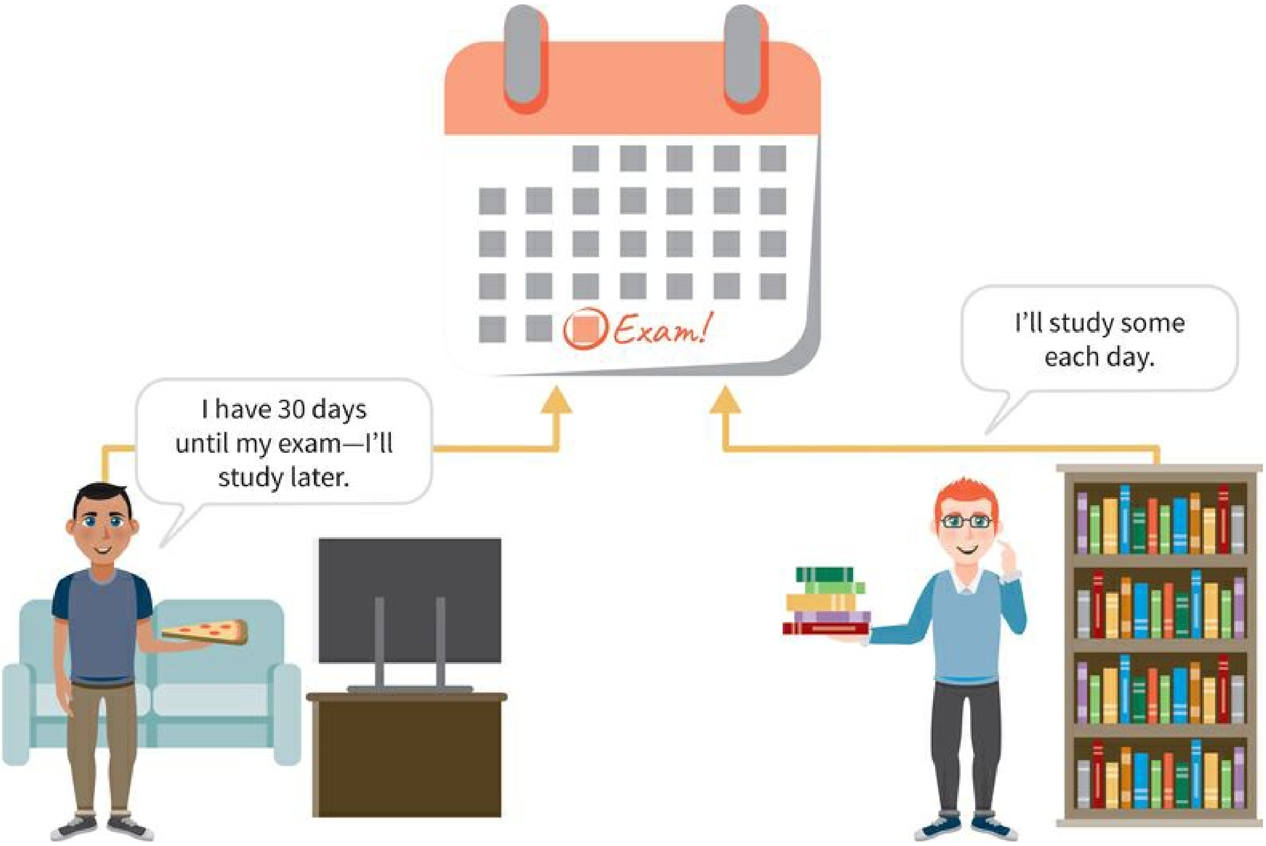
1a. Conflict Between the Present and the Future

Procrastination is placing more value on the present at the expense of the future. The conflict between choosing between today and the future is shown in the illustration below.

- Procrastinating the start of a long-term assignment or project, whether at school or at work, is an example of how people often choose to spend their time doing those things that are most comfortable rather than most important.
- This short-run choice is often at odds with someone’s long-term best interests.
- Long-term outcomes are largely determined by the daily decisions people make.

HINT

Although sometimes you might think you can’t control how your time is spent, in most situations you actually do have choices.



TERM TO KNOW

Procrastination

Placing more value on the present at the expense of the future.

1b. Hyperbolic Discounting

Procrastination can get so bad that when the time comes to act, some people often choose to put off doing something again and again. This happens because of **hyperbolic discounting**, in which as the time to act nears, the value of future benefits from taking action is perceived to decrease relative to other immediate alternatives. Consider the problem some people have maintaining their weight.

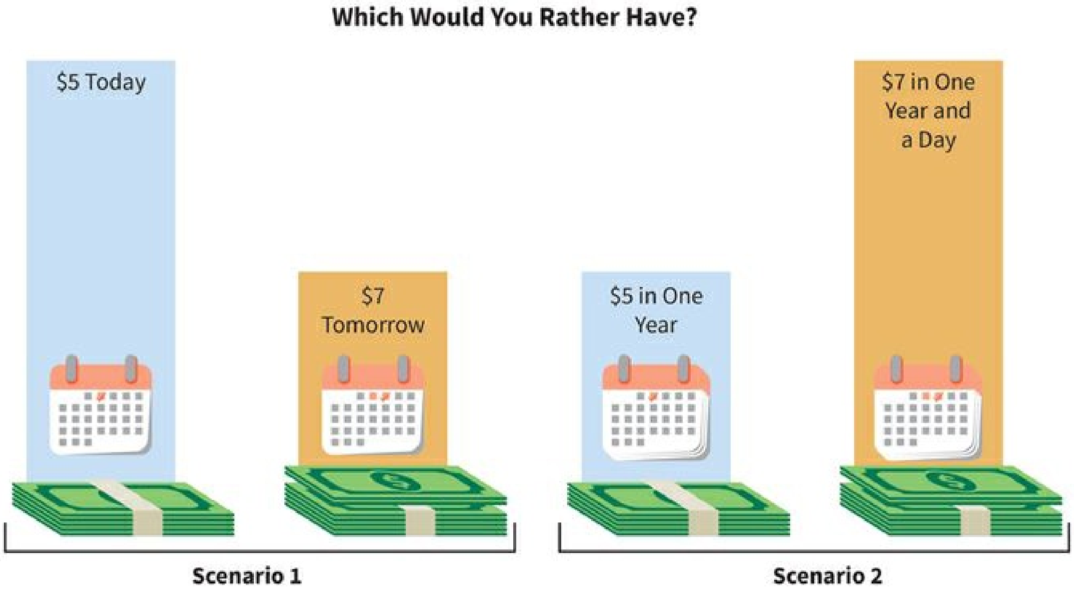
- Many people who want to lose weight struggle to maintain a healthy diet.
- They might pledge to cut down on food later, but when "later" comes they fall back into a pattern of eating impulsively. Often, it is only after a doctor informs them that they must change their food choices or risk serious health issues that they stick to a diet.

As this example illustrates, people tend to undervalue the future, relative to the present, and to procrastinate until some exterior influence, such as a deadline or a doctor's orders, forces them to act.
This same philosophy extends to financial decision making. Here's an example from the personal finance world. Let's say that someone offered you the following deal: "You can either have $5 today or $7 tomorrow." What would you take? Remember, there is no correct answer with this type of question. Now assume the same person comes along and asks, "Would you prefer $5 in one year or $7 in one year and one day?" Again, what would you answer?

- When asked nationally, as shown in the column chart below, 66% of Americans took the $5 in the first situation, but they switched preferences and took the $7 in the second scenario.
- That really is not logical or consistent. *In either case, they would have received an extra $2 just by waiting a day.* Yet most people will not wait one day when faced with a short time horizon, but they will gladly wait

the extra day when the time horizon is longer.

The inconsistency in waiting based on how close or far away the reward is (as measured by time) is an example of hyperbolic discounting.



Productivity: Skill Reflect

Who do you think is more productive? Someone who procrastinates, or someone who is proactive and can see the value of patience?

TERM TO KNOW

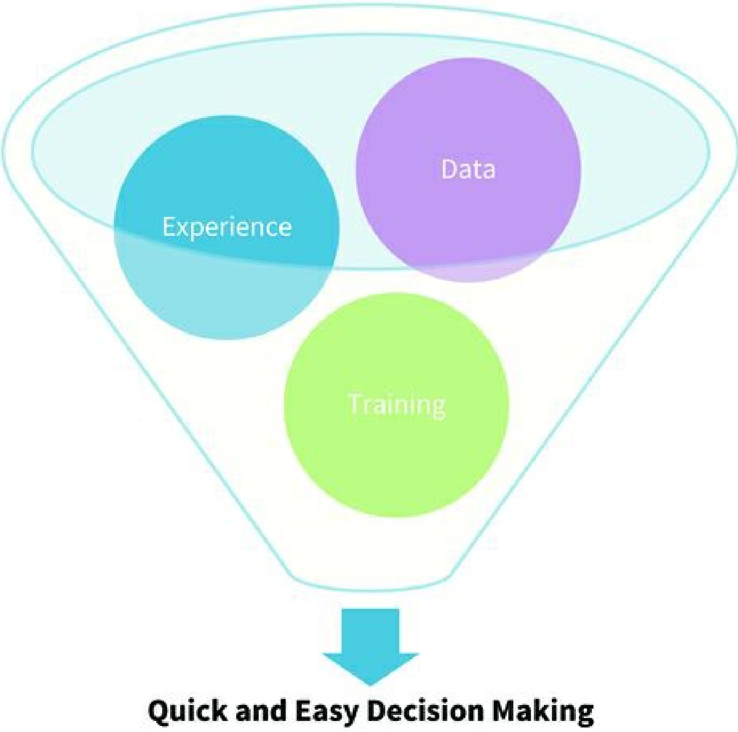
Hyperbolic Discounting

The perception that the value of future benefits is lower than that of an alternative available right now.

2. Heuristics

We all make many financial decisions each day. Behavioral economists study how people go about making these decisions. It turns out that our brains are wired to be efficient during the decision-making process. To simplify things, our minds use **heuristics** to make decisions more quickly and easily than if we were to labor over every choice. As shown in the following illustration, heuristics act like a funnel that takes a lot of information and condenses things down to a decision-making shortcut.

- Heuristics are based on past experiences or learning that the mind applies to new situations.
- Most heuristics are automatic and rarely used with forethought.
- Although heuristics can help you make quick decisions, they sometimes lead to problematic choices and outcomes.



Not surprisingly, most heuristics apply directly to financial management decisions. Consider the following examples.

- When making an estimate, always be conservative (don't be overly optimistic).
- Never buy stocks on Monday.
- Shop for a new car at the beginning of the month, but buy the car at the end of the month.

As these examples illustrate, heuristics can either help or hinder you as you move along your financial journey. Let's take a look next at some common heuristics that can lead you astray when making financial decisions: status quo bias, loss aversion, and optimism bias.

TERM TO KNOW

Heuristics
A decision-making shortcut for processing a lot of information.

2a. Status Quo Bias

The **status quo bias** is your personal preference for keeping things just like they currently are. This bias is prevalent because most people are usually comfortable with their current situation, even when much better options are available. Those who fall prey to this heuristic tend to:

- Overemphasize the good aspects of their current situation.
- Underestimate the benefits that come from making a change.
- Fear the possibility of making a wrong decision regarding a new situation.

Agility: Skill Tip

Strong agility skills can help give you confidence to make sound decisions. You can better understand the value of changing your ways given changes in your circumstances.

DID YOU KNOW

Whenever you hear someone say, “If it isn’t broken, don’t fix it,” they are exhibiting a status quo bias. It is often too easy to get stuck doing the same old thing, even if the past behavior has not been particularly beneficial. As shown in the following illustration, the status quo bias can lead to procrastination by overvaluing the present situation compared to the gains that could be received from a new opportunity. Over time, the status quo bias can lead to missed opportunities as a result of continued inaction.

TERM TO KNOW

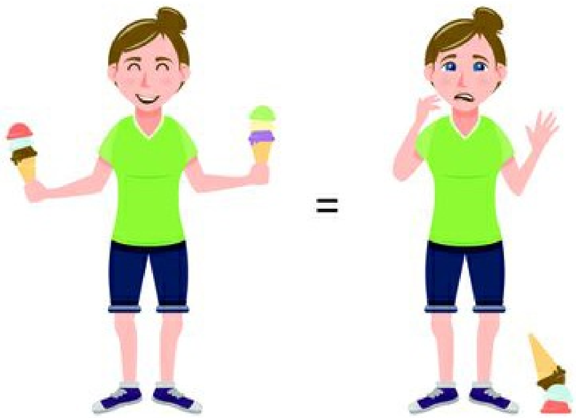
Status Quo Bias

A personal preference for keeping things just like they currently are.

2b. Loss Aversion

Most people dislike losing, especially money. In other words, people tend to be**loss-averse**.

- Research indicates that for individuals to be indifferent between the equal likelihood of gains and losses, the potential gains need to be nearly *twice* that of the potential losses. That means that you would need to have the same possibility of winning an additional $1,000 as you would of losing $500.
- Behavioral economists have concluded that if you lose, your emotional pain – your feelings of loss and the regret associated with making a bad decision – will also be two times as great as the joy of winning, as shown in this illustration.



As a result, people generally focus much of their attention on avoiding losses because the joy of a gain is smothered by the pain of a loss. The fear of loss also helps explain the status quo bias.

How does this loss-aversion heuristic translate to financial decisions? Consider that some investments over the long run, say, 20 years, have a consistent track record of superior performance. However, these same investments, over the short run, might gain and lose value regularly. People who are loss-averse tend to focus on these short-term fluctuations rather than on the 20-year payoff. Over time, they will miss out on benefiting from long-term gains, even when they have the time and resources to deal with a short-term loss.

TERM TO KNOW

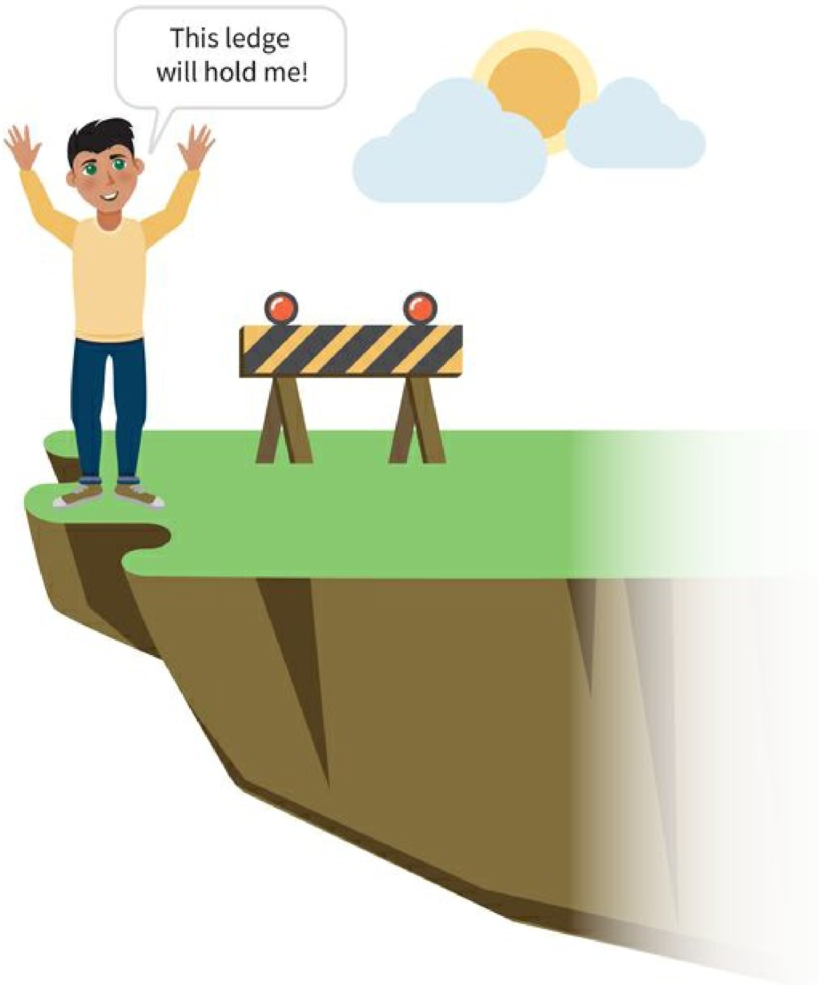
Loss-Averse

A general dislike of losses.

2c. Optimism Bias

Although people are generally loss-averse, there are others who think that they will rarely, if ever, experience painful losses during their lifetime. These people suffer from an **optimism bias**.

- Most people are generally optimistic and believe that they are, at a minimum, above average in most daily activities.
- There is nothing wrong with being optimistic, unless it blinds you to reality. Being overly optimistic can lead some people to discount the risks associated with a decision.



TERM TO KNOW

Optimism Bias

Believing that one will rarely, if ever, experience painful losses during one’s lifetime.

2d. Confirmation Bias

Say Jake buys stock in a company without doing any research. If the stock rises in value, Jake might attribute the success of the investment to his stock-picking skill rather than luck. When this happens, Jake may then go on to find reasons to confirm the assessment of his stock-selection "skill" and ignore any evidence that his investment success was based on pure chance. This is known as a **confirmatory bias**, which leads to overconfidence in future decisions. Thus, lucky novice investors like Jake can quickly become overly optimistic and overconfident, which can be a devastating combination for long-term investment success.

TERM TO KNOW

Confirmatory Bias
Ignoring evidence that investment success is based on pure chance, which leads to overconfidence in future decisions.

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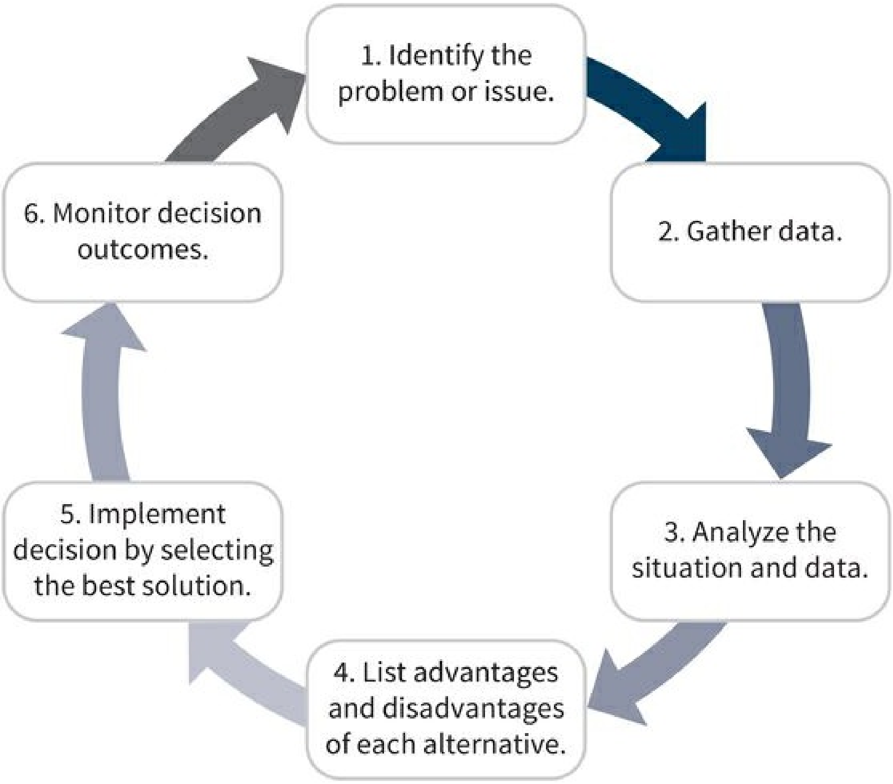
3. Using Heuristics as a Decision-Making Tool

When it comes to making any type of major decision – particularly a financial decision – financial planning experts recommend that you use a formal decision-making process, such as the one shown in the illustration below.

1. **Identify the problem or issue.** For example, say you want to rent a new apartment that is closer to school.
2. **Gather appropriate facts and data about the situation.** You should visit available apartments and make notes regarding the rent, utilities, and other expenses involved with each option.
3. **Analyze the data you have collected.** You should evaluate how each option adds up in terms of, for example, location and price.
4. **List the viable alternatives and select the best one.** It's also important at this point in the process to determine acceptable alternatives. It might turn out that the place you really want to rent has already been taken. If this were to happen, you need a good back-up plan.
5. **Implement the decision.** You need to make the commitment and sign the lease.
6. **Monitor outcomes.** If your apartment meets your expectations, you won't need to do anything. But if your landlord refuses to fix the plumbing or other things change, you'll need to start the apartment search over again.



SUMMARY

In this lesson, you learned strategies to help you improve your decision-making in terms of your finances. **Procrastination** is putting **more value on the present than the future**. This can hurt your productivity and long-term financial interests. **Hyperbolic discounting** is the act of continually pushing back deadlines because the perceived long-term benefit diminishes as the deadline draws closer.

Heuristics are how we apply our experiences to new situations. For example, some of us carry a **status quo bias** where we might overestimate how "good" things are right now. Strong agility skills can help overcome this. Others have **loss aversion**: avoiding risks while sacrificing favorable outcomes that can come from taking a calculated chance. Some people exercise an **optimism bias**. Generally, this is a positive heuristic, but it can lead to overconfidence and poor performance in extreme cases. Another heuristic leading to overconfidence is **confirmation bias**, which is pairing a success with misguided rationale for why that success took place.

We can all **use heuristics as a decision-making tool**, especially if we follow an established decision-making process that's proven to work. You saw a six-step process in this lesson.

TERMS TO KNOW

Confirmatory Bias

Ignoring evidence that investment success is based on pure chance, which leads to overconfidence in future decisions.

Heuristics

A decision-making shortcut for processing a lot of information.

Hyperbolic Discounting

The perception that the value of future benefits is lower than that of an alternative available right now.

Loss-Averse

A general dislike of losses.

Optimism Bias

Believing that one will rarely, if ever, experience painful losses during one's lifetime.

Procrastination

Placing more value on the present at the expense of the future.

Status Quo Bias

A personal preference for keeping things just like they currently are.