

# ADVICE INSIGHT

## Framing how we think about our money

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**“I used to think that the human brain was the most fascinating part of the body. Then I thought, what part of my body is telling me that?”**

- Erno Philips (American entertainer/Actor)

How often do we stop to think about how we think? As a species we have made great industrial and technological progress over the last few centuries, but thousands of years of evolution have not changed the way our brains are pre-programmed to think. For example, we still use our caveman fight or flight mode to make decisions in the twenty-first century. So much for evolution! Admittedly, fight or flight may be useful in a dark alley but, as we demonstrate, when it comes to investing it is disastrous.

The modern human nervous system is comprised of approximately 100 billion neural functioning cells, supported by what has been estimated to be almost ten times that number of other “supporting” cells. The cabbage like structure making up our cerebral cortex is still largely a mystery to medical science. For most of us, mastering the emotional signals our brain sends out is a lifelong voyage of discovery. Not surprisingly humankind has developed tools to help, such as anger management groups or Prozac for depression. What is surprising is that, until recently, there has been little research into whether our brain, and the emotions it creates, is harmful or useful when we invest.

Studies show our brain is a learning organ. Experiences from previous events and their outcomes are stored for future reference and these create responses when the event re-occurs. When a past outcome had pain associated with it our brain teaches us to avoid it in the future.

So far so good, but this learning mechanism sometimes works to our detriment. This is certainly the case when it comes to dealing with complex or unpredictable events like investment markets. What may on the surface look like a similar situation to one we have encountered in the past (with painful consequences), can in fact be very different when carefully analysed in the cold light of day - without our pre-programmed emotional response. In short, when it comes to investing, our brains play tricks on us.

Here are a couple of examples.

### Framing bias

**“Rose coloured glasses are never made in bifocals. Nobody ever wants to read the small print in dreams.”**

- Ann Landers (Agony-aunt for the Chicago Sun-times 1943)

Framing bias is fondly known as the “tinted spectacles effect”. Framing bias occurs when our decision (for example to take risk or not) is influenced by how the question is put to us.

Nobel laureate Daniel Kahneman worked with Amos Tversky to study the effect of framing bias when it came to making investment decisions. In 1979 they developed Prospect Theory, a theory that describes how people make decisions between alternatives that involve risk. They observed that when making investment decisions which involve risk, humans have a tendency to take more risk with their investments when they are showing a loss and less risk with their investments when they have a profit.

In one of their studies, Kahneman and Tversky offered participants one of the following choices:

- Situation A: a sure gain of \$240; or
- Situation B: a 25% chance to gain \$1000 and a 75% chance of getting nothing.

In the above situation, 84% of people surveyed chose the more certain situation A. Kahneman and Tversky then offered the same participants one of the following choices:

- Situation C: a sure loss of \$750; or
- Situation D: a 75% chance of losing \$1000 and a 25% chance of losing nothing.

All of a sudden the same people were willing to gamble with their money! 73% chose the more uncertain outcome, situation D.

The way the situation was presented (or as technicians say, “the framing of the question”) actually changed peoples’ investment

behavior. Situations B and D have higher expected value than situations A and C, yet investors chose one high expected return and one low expected return. The example highlights that when emotions kick in we do not invest like the cool, calm and calculated machines we aspire to be but instead begin to gamble in desperation, often with disastrous outcomes.

## Hindsight bias

**“It is difficult to live in the present, ridiculous to live in the future, and impossible to live in the past. Nothing is as far away as one minute ago.”**

- Jim Bishop (Journalist for New York Daily Mirror 1930-1943)

When Cher sang “If I could turn back time...” she might well have been lamenting an earlier investment decision. If so, she probably fell into another trap that our mind likes to play when we invest. When faced with a poor investment outcome the human mind will often try to tell the user that, in retrospect, it is obvious why this would be a bad investment. In reality, there are often good reasons why investors are attracted to bad investments. Even a good investment can experience periods of poor returns. Psychologists attribute hindsight bias to our brains trying to learn how not to make the same mistake again. In order to do this we trick ourselves into believing that we should have known better.

Having a brain which is programmed to tell you it was obvious in hindsight leads to all kinds of poor future investment decisions. As investment professionals like to say, “Hindsight Harry” might have the perfect investment track-record but he is no help with what to do for tomorrow.

Hindsight bias will not stop us getting caught up in the next Asian crisis, dot-com bubble, global credit crunch or housing market slump. It will just make us feel like we should have known better.

So we are fallible. No surprise there. A true cynic could say that framing bias leads to investment bubbles and hindsight bias prevents us from learning from them.

## A better way?

The first step toward creating a solution is recognising that there is a problem. As a consequence, we put considerable effort into researching not only which investments to put into our clients’ portfolios but also how clients will feel about their financial plan over time. Our objective is to structure and manage clients’ investments in a manner that does not put

them in the position where they have to make an emotionally charged – and possibly irrational – decision.

How can this be done in investment markets where uncertainty and risk are ever-present companions? Goal based advice focuses on understanding each client’s unique financial goals. These tend to range from the essentials with which our lives are not complete such as daily living costs, health care and visiting children or grandchildren, through to the “would love to if we could afford it” goals. A goals based plan does not remove the uncertainty of global investment markets but instead ensures a client’s plans are structured so that they have sufficient capital to meet their essential lifestyle goals through low risk, stable investment solutions. We have found that when clients know that their essential goals (which the strongest emotions are associated with) are taken care of, clients are able to breathe easier. This means that no matter what type of investment environment they find themselves in they are more able to make thoughtful, open-minded decisions about how to invest the remainder of their capital. This in turn enables them to make better investment decisions, stick with a programme and ultimately achieve a more rewarding outcome than if they had tried to think it through on their own.

Structuring financial plans and managing clients’ capital in a way that prevents emotionally charged – and potentially irrational – decisions not only ensures clients feel better about their financial plans, it also leads to better financial outcomes.

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