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TOPIC #8: Behavioral Heuristics

PROMPT: Explain how common behavioral characteristics of individuals may lead to poor financial decisions.

In actual practice, average investors entirely display numerous violations to rational decision making models and economic behavior models that can lead to poor financial decisions. One common behavior is overweighting certainty. In a positive domain where economic gain is reached, often an investor will become overly risk averse and forego additional upside that may have otherwise been achieved within the client's original risk/reward profile range. In a negative domain overweighting certainty leads to an increase in risk seeking behavior, which may overtly violate one's risk tolerance and lead to further losses (Kahneman & Tversky, 1979, p. 268).

Similar to overweighting certainty is the common behavior of "possibility". This is an example heuristic that violates the expected utility theory's expectations of rationally assessing probabilities. Rather than aligning one's decisions to the odds alone, investors commonly assign disproportionate decision weights. With possibility effect, playing the lottery is a prime example of an investor becoming indifferent to an extremely small chance for reward if that reward is extremely large and attractive (Kahneman, 2013, p. 312).

Priming is another common influence to behavior, sometimes consciously and other times unconsciously. Once an investor is given an idea, that person's decision making is largely influenced by associations to that idea (Kahneman, 2013, p. 52). An example if speaking about food, a subject may fill in the blank S O _ P with a U, but if talking about bathing a subject may fill in the blank S O _ P with an A. The media, one's co-workers, neighbors, family and friends may all have a subtle influence on behavior which left unrealized could lead to poor financial decision making.

Similar in subtly, a common finding in evolutionary neurobiology concludes the more complex a person's cultural habitat, the more advanced and optimum is one's cognitive maturation. The application suggests the more physical variance in one's environment (landscapes, buildings, water systems, etc), one's social diversity and the complexity of work duties lead to optimized cognitive flexibility and fuller expression of IQ—making greater potential for better financial decision making. Conversely, low-stimulating environments that lack technosocial complexity showed empirically attenuated cognitive capacity (Greiffenstein, 2011, p. 358-359), and may lead to poorer financial decision making—worth further examination, indeed.

When it comes to opt-in retirement plans, nearly 60% of participants spend less than two hours on the decision. Procrastination is one thing, but rushing the decision can also lead to devastating financial outcomes. The common behavior is looking for shortcuts to determine savings rates such as arbitrarily

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choosing contribution rates as multiples of 5% or meeting the employer maximum match percentage instead of determining an appropriate percentage for the individual's future savings goal, which is often a larger number (Benartzi & Thaler, 2007, p. 84-85). Another common behavior for 401k participants is to lean on past performance to determine future performance, and such extrapolation is a form of poor market timing—buy high and selling low (Benartzi & Thaler, 2007, p. 90). There are also peer effects, where a participant allocates to what friends and families have endorsed rather than what is suitable to the client specifically. The results of self-allocation rank BELOW the average of all portfolios and especially to professionally managed accounts (Benartzi & Thaler, 2007, p. 95).

References:

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- Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47(2), 263-292.

No investment strategy can guarantee a profit or protect against loss. All investments carry some level of risk including the potential loss of principal invested.

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