The field of behavioral finance is not new, but employing its core tenets is gaining favor among investors, advisors, and plan sponsors who recognize its value in influencing sound financial decisions.

Emotions can have a powerful impact on financial decisions and can lead to errors resulting in losses or missed opportunities over a lifetime of investing. Understanding how many of us make decisions can help individuals avoid errors and instill the discipline needed to build and maintain wealth. Plan sponsors can also use this knowledge to design retirement plans to help reduce mistakes by plan participants and maximize long term outcomes.

Behavioral finance, an extension of behavioral economics, is based on the premise that investors do not always process information or make decisions rationally. Instead, they often are influenced by emotion and rely on intuition to make decisions – sometimes very rapidly, as in impulse buying. The individual just “knows” it’s a good decision. Richard Thaler, PhD, sometimes referred to as the father of behavioral finance, first noticed a difference between the then-accepted view among economists that investors made rational choices and the actual choices made by investors. That was in the 1960’s.

Shlomo Benartzi, PhD, another leading behavioral economist, notes in a 2011 paper that Nobel laureate Daniel Kahneman used a framework of “two minds” in describing how individuals make decisions. Each individual possesses an intuitive mind that leads to rapid decisions and a reflective mind that is slower, analytical and deliberate, according to Kahneman.¹

Classical economists believed that individuals are rational, self-controlled, and make decisions based on self-interest. But behavioral economists such as Kahneman and Thaler found that individuals are not always logical or as disciplined as they need to be to make good decisions. Investment decision making often is influenced by the intuitive mind or emotion rather than logic. Kahneman refers to the two types of decision making as System 1 – quick and automatic, and System 2 – thoughtful and deliberate. Thaler made a distinction between “humans” – intuitive and emotional, and “econs” – logical and rational, like Star Trek’s Mr. Spock.

People make intuitive decisions every day, but it can be difficult to know which are correct. And if an intuitive decision is in error, it can have significant and negative consequences, a result often painfully clear when the decision concerns finances. Many individuals err by failing to save – or save enough— for retirement even though they have access to retirement accounts through an employer or easy access to IRAs or other savings options to build a nest egg. Individuals often prioritize paying short-term bills ahead of long-term goals like saving.

The importance of behavioral finance – and its challenge for advisors working with investors – is to find ways to help people avoid the cognitive illusions, biases, and intuition that lead to irrational decisions. Investors obviously aren’t trying to make poor decisions, but they can be swayed by emotion, especially during periods of economic volatility. Let’s explore these behaviors.
Examples of irrational investor behaviors

Inertia – Doing nothing is often the easiest choice. Even investors who want to save for retirement or know they should rebalance their portfolios often fail to take action.

Myopia – A focus on the near term is detrimental and prevents an individual from visualizing future financial needs. It’s often the reason many people wait too long to save for things such as college costs, emergencies, and retirement.

Loss aversion – There is more pain in losing money than there is pleasure in an equivalent gain. Often, investors focus on the potential for loss rather than sticking to a long-term, disciplined financial plan.

Herd behavior – Many investors are swayed by the excitement of a stock bubble, but few recognize it as it occurs. Bubbles often start out rationally, with a good example being the dot.com bubble in 2000. The development of the Internet brought innovation and helped many companies capitalize on that growth, but it soon gave way to excessive valuations and eventual collapse.

Anchoring – Investors sometimes focus on a single piece of information, such as a stock price. An investor may hold on to an investment at a loss hoping it will get back to the price they bought it at even if there are more productive investment opportunities.

Mental accounting – People often compartmentalize money for different purposes. Yet this can lead to irrational behavior such as setting aside savings for a vacation while at the same time holding high interest credit card debt.

Gambler’s fallacy – The error in this behavior is that it’s based on the 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. A common illustration in investing is when investors believe that because a stock or fund has declined significantly, it’s bound to go up.

How individuals can avoid irrational behavior

Even the most disciplined, savvy investors can be tempted to go with the crowd or to act on a hunch, especially during downturns or periods of volatility. Here are some recommendations for recognizing the potential for errors and avoiding costly mistakes.

Awareness – Know yourself and think about how you make decisions. When considering an investment, or a decision to buy or sell, step back and list the pros and cons, evaluate what is fact and what is opinion and how this decision will affect your finances over the long term.

Discipline – Create and maintain an overall financial and retirement plan and stick to it. Resist the temptation to bail out during volatile times, knowing that a buy-and-hold strategy performs better over the long term than trying to time the market. At the same time, discipline also can mean knowing when to sell. Losses and gains may happen over time, so don’t succumb to loss aversion and do nothing when your financial plan indicates you should make a change.

Pay yourself first – Prioritize retirement savings and set up an automatic investment plan that dedicates a set amount each month for important long term goals. For many, myopia sets in and all the available money will get spent on short-term wants with nothing left at the end of the month for long term needs such as retirement.

Put it in writing – Some investors work with advisors to set up a written investment strategy that includes scenarios and how they would act under those circumstances. This allows for flexibility within the parameters of a financial plan and helps avoid making decisions based on emotion. For example, the plan could detail action to be taken if the market decreased by 20% or increased by 20%. These plans are not binding agreements but can prove helpful if an investor begins to doubt his or her long-term strategy. A written plan provides a roadmap when the emotion of intuition takes hold.
**Visualize your future** – Counter potential myopia by thinking about your life 10, 20, and 30 years in the future, including the lifestyle you want and the lifestyle you will be able to afford with a disciplined financial plan. Compare that with the potential savings over time in your financial plan to help stay on course.

**How plan sponsors can use behavioral finance lessons to help participants**

Some plan sponsors provide tools to help retirement plan participants avoid irrational behavior. When available, participants can use these options in an effort to increase retirement savings at any age or stage of their careers.

**Automatic enrollment** – When new employees begin at a company, they are automatically enrolled in the retirement plan and are not required to sign up. Employees begin participating in the retirement plan immediately unless the employee opts out. “Enroll” in this context means that deductions from wages are contributed to the retirement plan on the employee's behalf.

**Automatic step up** – Similar to auto enrollment, plan sponsors can include a provision that allows employers to increase an employee's contribution to a retirement account at regular intervals to gradually increase the overall contributions over time. These increases can be set up to occur at any interval and frequently are designated to occur when an employee receives a pay increase so that there is little or no decrease in net pay.

**Default investment option** – In the past, employees who were automatically enrolled were placed into a default investment option which was often a low-risk vehicle, such as a money market fund, that did not offer much opportunity for growth. The problem was that many new employees were young and had a long time to go until retirement. The Department of Labor, the organization that oversees retirement plans, now allows plan sponsors to select a more age appropriate default option such as target date mutual fund or a balanced mutual fund that offers employees more potential for long term growth of their investment.

**Conclusion**

Plan sponsors can help retirement plan participants take steps to improve their likelihood of a comfortable retirement by designing plans that not only make it easy to save for retirement but help them avoid costly errors in judgment. Likewise, individual investors who can resist the influences of emotion and intuition can improve their ability to make sound financial decisions as they save for retirement.

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1. Behavioral Finance in Action, Shlomo Benartzi, PhD, 2011

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