

# Tips To Help Avoid Common Money Mistakes

Self-inflicted wounds are the worst. Knee-jerk, emotion-driven views of our finances can do more to mess up our portfolios than almost anything short of another 2008-09 crisis. Learn how you can strive to avoid common money mistakes.



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Thinking clearly about money is challenging. Acting in alignment with your goals about money is also challenging. Most of us want to be good stewards of our money and make smart money decisions that give us a good cushion for our retirement, yet most of can fall prey to five common money mistakes:

- Loss aversion
- Confirmation bias
- Herd mentality
- Choice paralysis
- Anchoring

## **Loss Aversion**

If your retirement portfolio increases by \$20,000, you probably feel pretty happy. But if your retirement portfolio decreases by \$20,000, you may experience this loss a lot more emotionally. Why? Because it is part of our nature as humans to protect what we have—particularly our money or other assets.

Most people, maybe including you, suffer from this bias. We are hard-wired as humans to react more intensely to a loss than a gain of the same magnitude. Knowing how our brains work we can better manage our emotional response and look at the situation more objectively.

A loss might compel us to take an action that would be unwise, as we try to make up for it.

## **Confirmation Bias**

We like to know that we are right. It feels affirming to be around people who think and feel like we do. Imagine that your investment portfolio is decreasing along with the overall market and this makes you feel uncomfortable. What should you do?



If you fall prey to confirmation bias, you may choose to read only the information that fits with your thoughts and opinions—and ignore information that could otherwise prove useful in making an informed decision.

To help minimize confirmation bias, remember that informed decision-making is comprehensive and includes information that fits with your pre-existing beliefs and, more importantly, information that contradicts your pre-existing beliefs. In short, seek contrary evidence to be an informed decision maker.

## **Herd Mentality**

Most of us are social beings. Consider the cliché of “keeping up with the Joneses” when choosing which house or car to buy. It captures the essence of the herd mentality. We are designed to seek safety by being part of the group rather than being alone. This tendency to join the herd often happens when we make financial decisions.

Imagine if your family, friends or co-workers are buying gold because they are nervous about the stock market, then it is likely that you will buy gold too. Who wants to feel left out? This tendency makes sense emotionally because it increases your sense of belonging. Nevertheless, the herd can often be wrong. Dead wrong.

To help prevent or minimize herd mentality, be a contrarian after you have comprehensively examined the situation with objective data and your own common sense. If you find it difficult to stand out among the crowd, then seek out individuals who are contrarian and consider their reasoning.

## **Choice Paralysis**

Choice generates feeling of independence and control. Yet, social scientists know that too many choices lead us to feel overwhelmed. Having too many options paralyzes us. Picture yourself in the Baskin Robbins Ice Cream store. The clerk asks, “How can I help you?” You pause and wonder whether you



want ice cream or yogurt, which one of 31-plus flavors, a small or a large, plain or with some topping, in a cone or a cup, and whether you will pay with cash or credit card.

All of these decisions are necessary just to buy ice cream. Imagine making a decision about which mutual fund or exchange-traded fund to buy. It has been said that there are more mutual funds than companies.

To help prevent or minimize choice paralysis, write down your goals. Remember how useful it can be to prepare a list of wants versus needs. Next, identify the criteria by which you will make the decision. With your goals in mind and relying upon the written criteria, weigh your options and make a decision. All decisions involve some level of risk, but making informed decisions can help minimize risk. The good news is that some decisions are reversible and many decisions are low impact.

## **Anchoring**

Anchors keep ships from moving. In behavioral finance, anchoring represents the point at which we evaluate how well things are going. For instance, let's assume you bought your house 15 years ago for \$500,000. After the financial crisis in 2008-2009, your house dropped in value to \$200,000. Today, your house is appraised at \$450,000. You are considering selling your house, but will the sale represent a loss ( $\$500,000 - \$450,000 = -\$50,000$ ) or a gain ( $\$450,000 - \$200,000 = +\$250,000$ )? It depends on where you drop your anchor.

To help prevent or minimize anchoring when making decisions, entertain new information such as changes in home values and embrace flexibility. It is critical, although difficult, to accept the reality that some things may never go back to their original state or value.

## **Conclusion**

These five common money mistakes are just a natural part of our human decision making process. By understanding our financial behaviors, we can



reduce the mistakes that can happen when making important career, investment, housing and retirement decisions. While you cannot always control the outcomes of your decisions, you can control the process by which you make a decision. Commit to making better money decisions today. If you aren't sure which direction to go...we are here to help! Contact us today



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