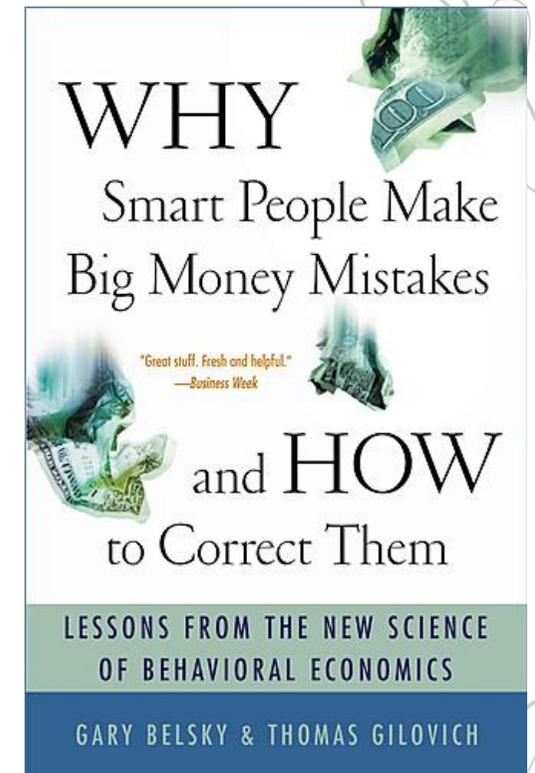


Why Smart People Make Big Money Mistakes and How to Correct Them

Gary Belsky & Thomas Gilovich © 1999

Psychology professor Gilovich and ex-Money magazine contributor Belsky believe you can put more money in your pocket by understanding the psychological causes behind making bad financial decisions. The work references the work of many pioneers in the new field of behaviour finance including founders' Amos Tversky and Daniel Kahneman. Seven behaviour traits are focused on and tips for countering them are offered.

This book provides more background to the colourful statement by William Bernstein who suggested “The biggest obstacle to your investment success is staring out at you from your mirror”



**ISBN 0-684-84493-1
Simon & Schuster**

Remember all money is “fungible”

Principle	Mental accounting	Loss aversion
Explanation	<p>We value some dollars less than others and more readily waste them</p> <p>We forget money is “fungible” (\$100 hard earned salary = \$100 tax refund = \$100 lottery)</p>	<p>People feel more strongly about the pain that comes from loss than the pleasure that comes with an equal gain – about twice as strongly</p>
Examples	<p>Allocate different money for different purposes losing track of overall allocation</p> <p>We spend “found money” eg. tax refund and credit card money more readily</p> <p>Bury small losses into a big one, eg. furniture w/ house purchase, new car extras</p> <p>Revolve a high-interest credit card balance while having low-interest savings elsewhere</p>	<p>Panic selling</p> <p>Hold on to losing investments and more prone to sell winners</p> <p>Choose smaller certain gain over an uncertain, but more probable higher gain (eg. certain 6% bond vs. 11% possible stock gain)</p> <p>Consider “sunk cost” when making new spending decisions</p>
Antidotes	<p>Break and analyse big purchases into components; question the extras</p> <p>Imagine paying or pay with cash instead of plastic</p> <p>Cycle “found money” into your savings a/c before spending, convert to \$/hr cost</p>	<p>Test your loss aversion (risk profile)</p> <p>Diversify to reduce magnitude of decline</p> <p>Write down your goals; raises the “ante”</p> <p>Forget the past – evaluate future potential</p> <p>Infrequently check your investments</p> <p>Enjoy segregated gains; integrate losses</p>

Don't be "innumerate"

Principle	Decision paralysis	Innumeracy
Explanation	We avoid making proactive decisions and have preference for status quo	Many are ignorant of key mathematical concepts important to make good decisions
Examples	<p>Delay acting until we design perfect decision</p> <p>Choose default or conservative option until get around to figuring out what to do</p> <p>Stay in a low paying job; fail to sell an investment; don't move to cheaper credit source; leave money in bank rather than invest</p> <p>"Twenty years from now you will be more disappointed by the things you didn't do than by ones you did do"- Mark Twain</p>	<p>1) Inflation – we react to nominal changes not percentage or real changes. We think a 100 pt market drop is the same now as it was when the market was 1/2 its value. We choose conservative investments and become more vulnerable to inflation</p> <p>2) Probability – bet retirement savings that active strategy will beat the index; stay out of the market after a crash</p> <p>3) Bigness bias – neglect small numbers that make big difference over time (eg. regular savings, fees)</p>
Antidotes	<p>Act! "someone invested in a lousy mutual fund is better off than someone who didn't invest"</p> <p>"Autopilot" [regular] invest to avoid making an endless series of market timing decisions</p>	<p>Invest regularly and for the long-term</p> <p>Don't be impressed by short-term success</p> <p>Raise your general insurance deductible</p>

Anchors away

Principle	Anchoring	Overconfidence
Explanation	We are biased to information that confirms our initial impressions; we discount that which doesn't fit	"You're probably not as smart as you think you are", ie. we tend to over-estimate our abilities
Examples	<p>Fix on a figure when selling (home, stock) even when its no longer worth that causing you to fail to sell (eg. sell losing investment)</p> <p>You're especially brand loyal</p> <p>You let sellers set the price rather than assess intrinsic value yourself. Experimental groups of agents appraised same home differently when given different list prices.</p>	<p>Planning fallacy – we are too optimistic about when we will implement strategies</p> <p>Think you are in better shape than you are</p> <p>Believe you can be more successful identifying worthy investments, managers or timing market ups and downs [then professionals or a 'dart board']</p> <p>Assign success to skill, failure to bad luck</p> <p>You don't benchmark your returns</p>
Antidotes	<p>Look for information that contradicts not supports your hypothesis</p> <p>Get second opinion; "broaden your advisors"</p> <p>Disregard price paid when selling</p> <p>Don't be swayed by property listing price</p>	<p>Add a 25% 'overconfidence discount' to any projection, eg. retirement savings, cost of home renovation</p> <p>Get a second opinion</p> <p>Objectively benchmark your returns</p>

The view is always the same when you are following the herd

Principle	Herd instincts
Explanation	Conforming to the behaviour of others is an accepted psychological principle extending beyond finance
Examples	Buy because others are buying and sell because others are selling Pay more for a stock/paintings/etc.. because others are; ‘cut and run when complete strangers value your investments for less Invest frequently and in hot stocks/funds Earn 6% pa investing in stock funds when the average fund earned 12% pa [US 1984-1995 average experience owing to chasing best performing funds and selling out of losing funds, just before newly bought funds lost momentum and the sold funds recovered]
Antidotes	Avoid hot investments and fads “Tune out the noise” – disregard most financial news and check prices/ valuation infrequently Be a long term value investor

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