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An Introduction to Behavioral Finance: Why We Make the Irrational Decisions We Do

“We cannot reason ourselves out of our basic irrationality. All we can do is learn the art of being irrational in a reasonable way.”

Aldous Huxley

By Les Carter

Unlike traditional economic theories that assume rational behavior by market participants, behavioral economics looks at the actual decision-making of individuals to understand how biases, mental shortcuts, and emotions influence their actions. While irrational, these influences are actually quite predictable. Since understanding what drives this irrational behavior is a critical step in helping us make better choices, we will be exploring several aspects of this topic throughout the year to help improve financial decision-making.

Traditional vs. Behavioral Economics

Traditional economics operates under the assumption that people have well-defined preferences and make well-informed, rational decisions based on those preferences in order to maximize utility. A traditional (or neo-classical) economist might say, for example, that consumers will allocate their limited time and money to goods and services that offer the highest marginal utility in order to maximize their overall satisfaction. In other words, someone who likes theater more than sports will spend more time and money going to shows than to games.

This seems reasonable, but reality, unfortunately, is much messier. A growing body of behavioral economics research shows that we are not perfectly rational. In fact, there are limits to our willpower, rationality, and self-interest, and these limits can lead to sub-optimal behavior. We eat more chocolate than we should. We text while driving. And sometimes we postpone that important doctor’s appointment.

These irrational behaviors extend even into market activities. We’re drawn to expert

predictions even though they have no predictive value. We overreact to short-term market fluctuations rather than considering the broader historical context. And though we know to buy low and sell high, our fear of missing out entices us to buy into the market at its peak and our aversion to losses tempts us to sell at the market's bottom.

What Guides Our Decision-Making?

Behavioral economics has identified several cognitive biases, mental heuristics (or shortcuts), and emotions that influence our decision-making in predictable ways.

Cognitive biases are systematic patterns of deviation from rational decision-making, representing our tendency to process information in a way that deviates from objective thinking. For example, "confirmation bias" is our tendency to notice, focus on, and give greater weight to evidence that fits with our own beliefs, while ignoring information that contradicts those beliefs. Evaluating new and different information takes more time and energy, so we don't prefer to do it. We much prefer thinking we are right than thinking we are wrong, so we tend to process information that agrees with us. But just because a certain way of thinking is easier or makes us happier doesn't mean it's best for our long-term interests.

Heuristics are mental shortcuts we use to simplify our decision-making. Heuristics can serve as efficient and time-saving cognitive tools, but they can also lead to predictable errors. The "availability heuristic," in which we rely on readily available information to make decisions, can lead us to overemphasize recent or memorable events. For example, a person who recently saw a documentary on sharks might overestimate the probability of a shark attack and avoid swimming in the ocean. Or an investor who read a front-page story about a potential recession might reduce equity market exposure in their portfolio even if doing so is inconsistent with their long-term goals and historical market data.

Emotions also play a pivotal role in shaping our decisions, often swaying us in directions inconsistent with a rational viewpoint. We probably can all relate to making decisions out of anger, fear, empathy, or exuberance. An exuberant investor might be overly optimistic and avoid due diligence and research that might better inform their decisions. Emotions come naturally to us, but that does not mean they should be the basis of our decisions.

How to Improve Our Decision-Making?

The first step toward improving decision-making is recognizing the existence and potential impact of these psychological factors. This realization helps us approach decisions with a more critical and objective mindset. It's much harder to avoid the availability heuristic, for example, if you don't realize it exists. Once we are aware of these potential pitfalls, we can

implement systematic decision-making processes, such as checklists or predetermined criteria, to help guard against irrational choices.

Armed with an understanding of how individuals use cognitive biases, heuristics, and emotions to make decisions, and equipped with systematic approaches to addressing those potential pitfalls, our limited rationality changes from a liability into an asset. Not only can we proactively sidestep potential errors and make choices better aligned with our own long-term goals, but we can anticipate and capitalize on the sub-optimal decisions of other market participants.

This is why, over the next several months, we will be reflecting on the numerous ways in which we are all prone to make irrational decisions — and exploring how to overcome these tendencies.

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