

January 29, 2024 – Wealth Planning Commentary

Don't Let Behavioral Biases Drive Your Plan

Behavioral finance explores the psychology behind investor decision-making. Investors who believe that they're acting rationally may be unaware of behavioral biases preventing them from achieving their objectives. A wealth plan can help shine a light on these biases and, if addressed, can improve the decision-making process. Balancing investor preferences with solutions that are optimal from a technical standpoint is a key component of wealth planning. Recognizing biases is the first step toward understanding how they impact your decisions.

Anchoring bias is when an investor relies heavily on a specific reference point such as a market high. Consider housing prices. Some saw their homes skyrocket in value a couple of years ago and are fixated on Covid era highs. Prices likely decreased since then. As a result, many homeowners are unwilling to sell at current market values. A strategy to help overcome anchoring is to develop a wealth plan. The process can provide clarity into whether 'giving up' a little value in the short term is detrimental in the long term. Often it isn't. Perhaps a seller must make a concession and sell at a slightly lower price. Selling can still benefit the owner if they prefer to live somewhere else. Happiness may offer more value than dollars.

Present bias leads many to prioritize immediate rewards over future payoffs. Spending money now rather than delaying is a form of instant gratification, and it's a big issue when someone spends beyond their means. This happens at all levels of wealth and behavior is challenging to curb given that we can purchase almost anything at the touch of the button. Nevertheless, there are strategies that may help reduce spending. Some can successfully slow themselves down. Make it a policy to wait three days before clicking 'check out' on that shopping cart, are the items still as desirable? Often there is a less expensive way to satisfy a desire, like leasing a high-end car instead of purchasing it. Another idea is to develop a spending plan and commit to it. This strategy establishes an 'anchor' spending amount and may encourage hesitation before purchasing an item.

Projection bias occurs when a person assumes that their needs and wants will remain constant over time. As we age, many of us change priorities and establish a different set of goals. Although projection bias is more prevalent in younger investors, people of all ages can experience it. It is challenging to plan for a lifetime when one is in their 30s, 40s, or even 50s. Building flexibility into a plan can help avoid strategies that are too limiting. Determine a conservative set of assumptions and Conservatively account for potential health issues, disability, premature death, and unforeseen expenses because these events do happen, sadly.

Status quo bias is also common, it's sneaky and potentially dangerous. With this bias a person is resistant to change. In wealth planning it may prevent clients from implementing advice around estate planning. The more a recommendation is explained and why a client should act the stronger the resistance. In these instances, acknowledging the obstacles and validating attitudes can help. Many understandably fear estate planning because it forces one to address their own mortality. Reframing the subject in a positive light may help. Estate planning provides closure of your affairs and an orderly transition of assets to heirs. Why cause unnecessary stress while your loved ones grieve your passing. Thoughtfully selecting agents like trustees and guardians helps to ensure your plan is executed according to your intentions. And of course, estate planning may help reduce taxes giving more opportunity to future generations. It can help to know that, when the work is finished, it can bring peace of mind.

In summary, recognizing and addressing behavioral biases is a key part of the wealth planning process. Understanding these preferences will help with the decision-making process and it can lead to actions that pay off in the long term. Please reach out to your Wealth Manager with questions about behavioral biases.

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