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**seven common mental money mistakes.** (Statistical Data Included) *Gary Belsky.*

**Abstract:** Seven common money-management mistakes are explored from a psychological perspective. Also discussed are ways in which banks can profit from an understanding of such mistakes.

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To Understand Your Customers, You Have to Know How They Think

Imagine you go to a store to buy a shirt, which sells for \$100. At the store, you learn the same shirt is on sale for \$75 at a branch five blocks away. Do you go to the other branch to get the lower price?

Now imagine that you've bought a ticket to a play. At the theater you realize you've lost your ticket, which cost \$150. Do you spend another \$150 to see the play?

What do shirts and plays have to do with banking? Quite a lot, as it happens. Both of these scenarios come from research in a science called behavioral economics. Pioneered in the 1960s by a pair of Israeli psychologists, Daniel Kahneman and Amos Tversky, behavioral economics combines psychology and economics to explain how people make decisions about money. Specifically, behavioral economics asks why people--even those with expertise and experience--make financial choices that are inconsistent, irrational and often costly. It asks, in other words, "Why do smart people make big money mistakes?"

Approaching an answer to that question is crucial for bankers who hope to thrive in the twenty-first century. Today's bank customers are confronted with an increasingly complex array of financial services and products. By learning how consumers make financial decisions, bankers can go a long way toward meeting depositors' needs and keeping them as customers. This article explores seven of the most common mental money mistakes and, in the box on page 24, offers six ways bankers can put this information to practical, and profitable, use.

1 Mistake

Mental Accounting

These examples may sound familiar, but bear with me.

Imagine you go to a store to buy a suit, which sells for \$500. At the store, you learn the same suit is on sale for \$475 at a branch five blocks away. Would you go to the other branch to get the lower price?

Now imagine you're going to a play, but you haven't bought your ticket, which costs \$150. At the theater you realize you've lost \$150 cash. You still have enough money to buy your ticket. Do you?

Compare these scenarios with those at the top of this article. Studies in behavioral economics tell us that more people will go to the other branch of the store to save on the shirt than would go to save on the suit. It is odd, because both scenarios offer the same choice: Walk five blocks to save \$25. By the same token, research suggests that most people would not buy another ticket to the play if they had lost a previously purchased ticket, but would if they had lost \$150 in cash. Here, too, both scenarios offer the same outcome: total out-of-pocket cost of \$300 for a product valued at \$150.

This variance in response reflects one of the most common, and costly, concepts of behavioral economics: mental accounting. In essence, this is the tendency to value some dollars less than others based on where the money comes from (salary vs. bonus, for example), how it is to be spent (down payment vs. vacation) or the size of the transaction. In our example, \$25 is thought significant when it's part of a \$100 transaction, but insignificant when part of a larger purchase. Similarly, for most people the first ticket scenario equals a total play cost of \$300, i.e., two tickets at \$150 each. But most people separate \$150 in lost cash and the \$150 ticket into two independent accounts. Those still unsure about the effects of mental accounting need only answer the following question: Which are you more likely to spend, \$1,000 from a savings account or a \$1,000 tax refund? That most people have answer to that question at all is the best proof of the effects of mental accounting.

## 2 Mistake

### Loss Aversion

Imagine you've been given \$1,000 and asked to choose between two options. With Option A, you are guaranteed to win an additional \$500. With Option B, you get the chance to flip a coin. If it's heads, you receive another \$1,000; tails, you get nothing. Which option would you choose?

Now imagine you've been given \$2,000 and are required to choose between two options. With Option A, you are guaranteed to lose \$500. With Option B, you are given the chance to flip a coin. If it's heads, you lose \$1,000; tails, you lose nothing. Now which option would you choose?

Once again, research suggests most people choose Option A in the first scenario (the sure gain of \$500) and Option B in the second (an even chance to lose \$1,000 or nothing at all). Again, the outcome in both versions is identical. With Option A--the sure gain in the first version or the sure loss in the second--you end up with \$1,500. With Option B, you have an even chance of winding up with \$1,000 or \$2,000. But by choosing Option A in the first case and Option B in the second, people reveal a willingness to take more risk if it means avoiding losses, and to be conservative when given the opportunity to lock in profits. Indeed, one of the bedrock principles of behavioral economics is that people are "loss averse," that is, they feel the pain that comes with loss more strongly than the pleasure that comes with an equal gain. In fact, they feel it about twice as strongly, which helps to explain why investors have such a hard time selling losing stocks. The pain of making the loss "final" by unloading the security often outweighs rational reasons for dumping shares.

## 3 Mistake

### Choice Conflict

Imagine you're thinking about buying a CD player, but you haven't decided which brand or model you want. Walking past an electronics store, you notice a sign advertising a popular Sony CD player on sale for \$99. You know this price is well below retail. Would you (1) buy the Sony, or (2) wait to learn more about other models.

Now imagine the same situation, except the store also offers a high-quality Aiwa disk player for \$159, which you know is a bargain. Would you (1) buy the Aiwa, (2) buy the Sony, (2) Wait to learn more about other models.

A strange thing happened when these scenarios was put before two different groups of people. The majority of one group, presented with the first scenario, said they would buy the Sony, while roughly a third opted to wait. But when another group of people was presented with the second situation, 25 percent said they would buy the Sony, and another 25 percent opted for the Aiwa. Half the people said they'd wait. In other words, the addition of a second good deal made people less likely to take advantage of either opportunity.

The obvious conclusion? The more choices people face, the more likely they are to do nothing. But, tellingly for marketers of financial-service products, researchers have found that diversity alone is not the determining factor in people's tendency to decide not to decide.

In another experiment, people were presented with a scenario similar to our second one, except that the Aiwa was replaced by a noticeably less appealing brand of CD player. In this case only 25 percent said they would wait to make a purchase. So more, and better, choices make choosing harder.

#### 4 Mistake

##### Regret Aversion

Mr. A. waits in line at a movie theater. When he gets to the ticket window he's told that as the 100,000th customer he's won \$100.

Mr. B waits in line at a different theater. The man in front of him wins \$1,000 for being the 1,000,000th customer. Mr. B wins \$150.

Who would you rather be, Mr. A or Mr. B?

Here's another reason why people find choosing so difficult. Most people, as expected, prefer Mr. B's position (up \$150) to that of Mr. A (up \$100). But, incredibly, a large minority prefer the opposite! These souls would feel so bad about missing out on the \$1,000 prize that they would effectively pay \$50 to avoid feeling regret over having been a step late to the theater. They are, in other words, classic victims of "regret aversion."

When combined with choice conflict, regret aversion helps to explain why more than half of all U.S. adults keep their money in money market funds, CDs or passbook savings accounts. With more than 7,000 publicly traded stock and bond funds--and a roughly equal amount of actively traded individual stocks--the prospect of choosing among them is thought too daunting.

#### 5 Mistake

##### Sunk-Cost Fallacy

Imagine you've been given tickets to a ballet performance. You're dying to go because you want to see Mikhail Baryshnikov before he retires. As you're getting ready to go, you learn Baryshnikov won't perform. In addition, a sudden snowstorm makes the trip to the ballet unpleasant, and somewhat

dangerous. Do you go?

Now imagine the same ballet, except you paid a fortune for the ticket and there's no chance of selling it. Do you go?

Most people choose to risk traveling in a dangerous snowstorm if they paid for the ticket, while staying home if they'd been given the ticket. But the distinction makes no sense: The money for the ticket is spent, or sunk, in either case. You won't get it back whether you go to the event or watch it on television. In fact, going to the ballet means incurring an extra cost, the chance of an accident, so the danger posed by the snowstorm should carry equal weight for whether the ticket is a gift or an out-of-pocket expense. That it doesn't--that there is more significance because we have spent money--is an example of the sunk cost fallacy, which more than likely springs from the admirable desire to "waste not, want not." That is, people try to justify past expenditures with present decisions. It's the reason many car owners continue to repair a lemon. And it's another reason so many people hold on to losing investments. They focus on what they paid for a stock or bond, rather than evaluating the security based on what it's worth today.

## 6 Mistake

### The Status Quo Bias/Endowment Effect

Imagine you've found a ticket to the most prestigious inaugural ball of the newly elected U.S. president. Now, a stranger offers to buy your precious ticket. What is the smallest amount for which you would sell?

Now imagine that you don't have a ticket to the ball, but you really want one. How much would you pay that same stranger for his?

Here's yet another reason why people hate making decisions: Humans are predisposed to liking things just as they are. Behavioral economists call this the "status quo bias," but it's often a manifestation of what is often termed the "endowment effect." This is the tendency for people to overvalue what belongs to them relative to the value they would place on the same possession if it belonged to someone else. The endowment effect helps to explain why most people would demand at least twice as much to sell the ticket to the inaugural ball than they would pay for it.

The endowment effect was demonstrated several years ago in a series of experiments at Cornell University. Half the students in an economics class were given a mug emblazoned with the school's logo. All the students examined the mug, which sold at the college bookstore for \$6. Given that the mugs were handed out randomly, it is unlikely that those who received the free mugs loved coffee, or Cornell, more than the students who didn't get mugs. The experimenter then conducted an auction of sorts to see how much money the mug owners would require to part with cups and how much the students who didn't have mugs would pay to own one. You can guess what happened: The median price below which mug owners were unwilling to sell was \$5.25, on average. That is, they wouldn't give up their newfound possession for less than that amount. Conversely, the median price above which mug buyers were unwilling to pay was about \$2.75. That is, they wouldn't pay more than that amount to buy a mug. The only way to explain this discrepancy is the endowment effect. The mere fact of ownership was enough to make mug owners value a pretty basic campus commodity almost twice as much as did students who didn't own the mugs.

The inevitable conclusion: Because people place an inordinately high value on what they have,

decisions to change become all the more loaded and difficult. To be sure, people manage to overcome this tendency all the time. If they didn't, folks wouldn't sell their homes, divorce their spouses, or trade in used cars for new ones. But to the extent that the endowment effect makes it hard to appraise accurately things in their possession, consumers may fail to pursue options that are in their best interest. And, if you think about it, the endowment effect is another manifestation of loss aversion: People place too much emphasis on their out-of-pocket expenses (what they have to pay now) and too little value on opportunity costs (what they miss by not taking an action).

## 7 Mistake

### Anchoring

With Genghis Khan in charge, the Mongols ruled most of central Asia, until he was killed in an ill-fated siege of a Chinese city. Please answer the following two questions. (1) Did these events happen before or after 151 A.D.? (2) In what year did Genghis Khan die?

One of the basic principles of behavioral economics is that in order to handle the multitude of decisions people have to make every day, they use a variety of short cuts or rules of thumb called heuristics. One of the most powerful is called "anchoring." This is the tendency to latch on to an idea or fact and use it as a reference point for future decisions.

Take another look at the puzzler above and try answering the questions. The first, of course, is a straw man, a random date, planted to establish an anchor. And chances are, 151 A.D. didn't seem quite right to you: too early. Still, when trying to come up with a more accurate date, "151" sticks in the mind and weighs down your estimate. The net result, in this case, is that your best guess is too low, too close to 151 A.D. (Genghis Khan actually died in 1227 A.D.).

Skeptical? A few years ago Cornell University psychologist J. Edward Russo put a similar problem before 500 M.B.A. candidates, though in that experiment Attila the Hun was the pillager of choice, and the second question asked participants to speculate on the year he was defeated, not the year of his death. Russo asked the students to generate the first number themselves, the benchmark date in question 1, by adding 400 to the last three digits of their own phone numbers. Interestingly, when that date happened to range between 400 and 599, the students' average guess was that Attila had been defeated in 629 A.D. But when the date they concocted was between 1200 and 1399, their average guess was 988 A.D. Although the students knew the benchmark date they had arrived at was meaningless, it still affected their guesses in a meaningful way. The more recent the date, the more recent their estimated year of Attila's defeat (which actually occurred in 451 A.D.).

Anchoring manifests itself in all manner of financial decisions. We respond to a sale because we focus on the "retail" price, which becomes our anchor. We buy or sell investments because we focus on target prices that are often arbitrary. Brand names prompt another form of anchoring: We're loyal to them because we believe they represent reliable products. Like a great many other heuristics, anchoring can be helpful in navigating the decision minefields people face every day. But a failure to understand the power of this and other behavioral economics tendencies can be costly indeed.

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### 1. Avoid Offering Too Much of a Good Thing

Choice conflict suggests that offering a range of product and service options is a good thing, but too many options serve only to confuse customers. Basic, luxury and mid-priced offerings are generally all you need to prompt consumers into action.

## 2. Bundling Works Wonders

One of the implications of mental accounting is that people prefer to "integrate losses." That is, they find it easier to justify expenditures when they are tucked into larger expenses. Fee structures or product offerings that reflect a bundling of services are often easier to sell than the individual components.

## 3. Trial Offers Produce Permanent Results

For centuries Oriental carpet salesmen have used the endowment effect to great advantage: They encourage the customer who can't decide between two carpets to take both home, and tell them that the store will pick up one or both if they're not to the customer's liking. Very often, the consumer falls in love with both carpets as soon as he comes to view them as self-endowed. That is, once a rug is on your floor you see it as your rug--and like it that much more. Similarly, selling banking products and services with trial periods, even unlimited ones, can be an effective marketing strategy.

## 4. Payroll Deduction Is a Powerful Savings Incentive

One of the little-known obstacles to saving is loss aversion. People have a hard time writing checks to savings plans or other investment options because they feel the current loss of buying power more strongly than the future gain of wealth building. By marketing payroll deduction plans as a pain-free savings vehicle, the interests of the customer and the bank are equally served.

## 5. Consumers Want Direction

it's hard to overstate the consumer's desire, conscious or otherwise, for guidance. Using published materials or, better still, human advisers to help customers frame financial choices in logical ways that help to avoid conflicts will have direct impact on the bottom line.

## 6. Some Offers Are Just Too Hard to Refuse

Car dealers have long understood the power of anchoring. Curiously, bankers have not. But the fact remains that services and products offered at "below retail" or "on sale" can't help but lure consumers who are naturally prone to anchor on the retail price and evaluate accordingly.

--G.B.

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