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## How Your Emotions Can Cost You Money

by David Futrelle  
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If you haven't been feeling emotional about money lately, you must have an excellent yoga instructor. There have been the rolling freak-outs about unemployment, the debt, and European defaults; meanwhile, investors seem to be inflating a bubble in tech.

George Loewenstein, a professor of economics and psychology at Carnegie Mellon, has devoted his career to figuring out how our complex and often mysterious emotions affect money and life decisions.

His field, known as behavioral economics, is now quite trendy — it's been embraced by would-be reformers ranging from the Obama administration to Britain's Conservative Party — but Loewenstein warns that understanding emotions doesn't lead to easy solutions.

He recently spoke with MONEY contributing writer David Futrelle; the conversation has been edited.

**What's the most important lesson you've learned about the role of emotions in people's economic behavior?**

It's dangerous to make long-term decisions based on short-term emotions.

**So just take a deep breath before making a big money decision?**

Not exactly. Often the problem isn't that we're too emotional. It can also be that we're unemotional now and don't appreciate how emotional we're going to be in the future. I call this an empathy gap — we don't fully empathize with our future selves.

**How would my inability to imagine how my future self will feel mess up my financial planning?**

My colleagues — chiefly, Leaf Van Boven — and I have studied the illusion of courage: People think they will be more willing to take risks in the future than they really will be. They underestimate the fear they will experience when they get into a fear-inducing situation.

In many of our studies, we asked people whether, in exchange for a payment, they would be willing to take social risks, like miming, dancing, or telling a joke in front of a group. When the performance is in the future — say, a week off — lots of people volunteer to do it, but then when the moment of truth arrives, most of the volunteers end up chickening out.

The same pattern applies to investors. When markets are calm, investors think they'll stand pat when the markets begin gyrating. But at the moment of truth, many end up bailing out, often at the worst moment.

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### **What's the best way to avoid this?**

Many people solve the problem by hiring investment professionals. Advisers I've spoken to have told me they view their job much more as one of preventing impulsive decisions than of picking the optimal portfolio.

Of course, having your portfolio managed by someone else can be costly. A cheaper, if likely less effective, strategy is the out-of-sight, out-of-mind approach. Put a chunk of your financial wealth into a portfolio you are comfortable with and then try, ideally, to forget about it.

### **Does the empathy gap affect savings decisions?**

The empathy gap tends to promote undersaving because we can't imagine either the pleasures of an affluent retirement or the pains of a lean one. Many investment firms have expended time and effort trying to figure out how to help investors imagine how they'll feel in retirement.

They want to know whether it's more effective to show an investor vivid images depicting the miseries of people who didn't save enough or images of happy people who did. The answer is "neither."

### **What would work better?**

A far more effective strategy is for investors to set short-term goals designed to accomplish long-term goals. Investment institutions should give their clients constant feedback about how well they are meeting their short-term goal to save regularly, whether the amount they put into savings this week will ultimately lead to a poor retirement or to a rich one. That's far more likely to create the kinds of immediate pain and pleasure that help people reach goals.

### **You once suggested a savings plan combined with a lottery, to make saving immediately enjoyable.**

Other countries do have lottery-based savings bonds. With British "premium bonds," for example, instead of getting a fixed interest rate, every pound you invest entitles you to a chance at cash prizes. I tried to pitch the idea of a lottery ticket where half the money would go to savings, though I had misgivings.

It would be bad if it encouraged people who had been saving to instead put money into the lottery. In any case, the state lottery authority I pitched it to wasn't interested because lotteries make a lot from "chum" — when people win, they spend the money on more tickets. The authority wanted winnings paid out in cash, so that people could buy more tickets; I wanted them to go to savings. We couldn't agree, and the idea never went anywhere.

### **So it's tricky to apply psychological insights to real life. In fact, you've recently warned that behavioral economics can be overdone.**

I've come to the view that behavioral economics solutions are often being used as a substitute for more fundamental efforts. British Prime Minister David Cameron is a big fan of behavioral economics and gave a talk in which he said, "The best way to get someone to cut their electricity bill is to show them their own spending, to show them what their neighbors are spending, and then show them what an energy-conscious neighbor is spending."

This idea plays on Bob Cialdini's research documenting the impact of social norms on behavior. It's a great idea, and leads to reductions in energy use of a few percent, but showing someone their neighbor's bill is not the best way to get them to cut their own bill. The best way is to charge an amount that reflects the true cost of the electricity, including social costs from importing oil, pollution, climate change, and so on.

Behavioral economics has a lot of great insights to contribute to public policy, but it will be unfortunate if it substitutes tried-and-true approaches involving taxes and regulation.

**Proposals for financial reform often hinge on disclosure — for example, making brokers say if they are paid to sell a product. Will that work?**

There's very strong evidence that disclosing conflicts of interest can have all sorts of perverse consequences.

For example, say you know that your doctor has a conflict of interest; that he's going to get a payment if you enter a clinical trial. What are you supposed to do with that information?

Most people trust their doctor and take his advice. But in our research we find that people giving advice do respond to having disclosed: They tend to be more vehement about their advice because they're worried it will be discounted. And they can justify this by saying to themselves, "I warned him." The net effect is the doctor, in this example, gives more emphatic advice, and people are more likely to follow it.

**You also say the disclosure can change how consumers react.**

Another important piece of the puzzle is what we call insinuation anxiety.

Suppose I recommend this clinical trial to you and there's no discussion of conflict of interest. If you say no, it probably just means you like the drug you're on now or you're risk-averse.

But what if I say, "By the way, I'm going to get \$1,000 if you join the clinical trial"? Now if you say no, it suggests you don't trust me. The paradox is that disclosing the conflict can make you trust the advice less, yet feel pressured to follow the advice.

Despite that, I believe in disclosing conflicts. If my doctor prescribes a drug, it's my right to know if he's getting paid by the manufacturer. The question isn't if disclosure is good or bad — it's good — but learning how to make it more effective. That's a major focus of our current research.

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