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# 7 Reasons Why Good People Make Bad Financial Decisions

SAVING & INVESTING

Jun 04, 2022 | 5 min read | Amy Freeman

## Key takeaways

- Cognitive biases can influence your money moves.
- Societal pressure and the pursuit of instant gratification also affect financial decisions.
- You can overcome biases and improve your financial decision making.

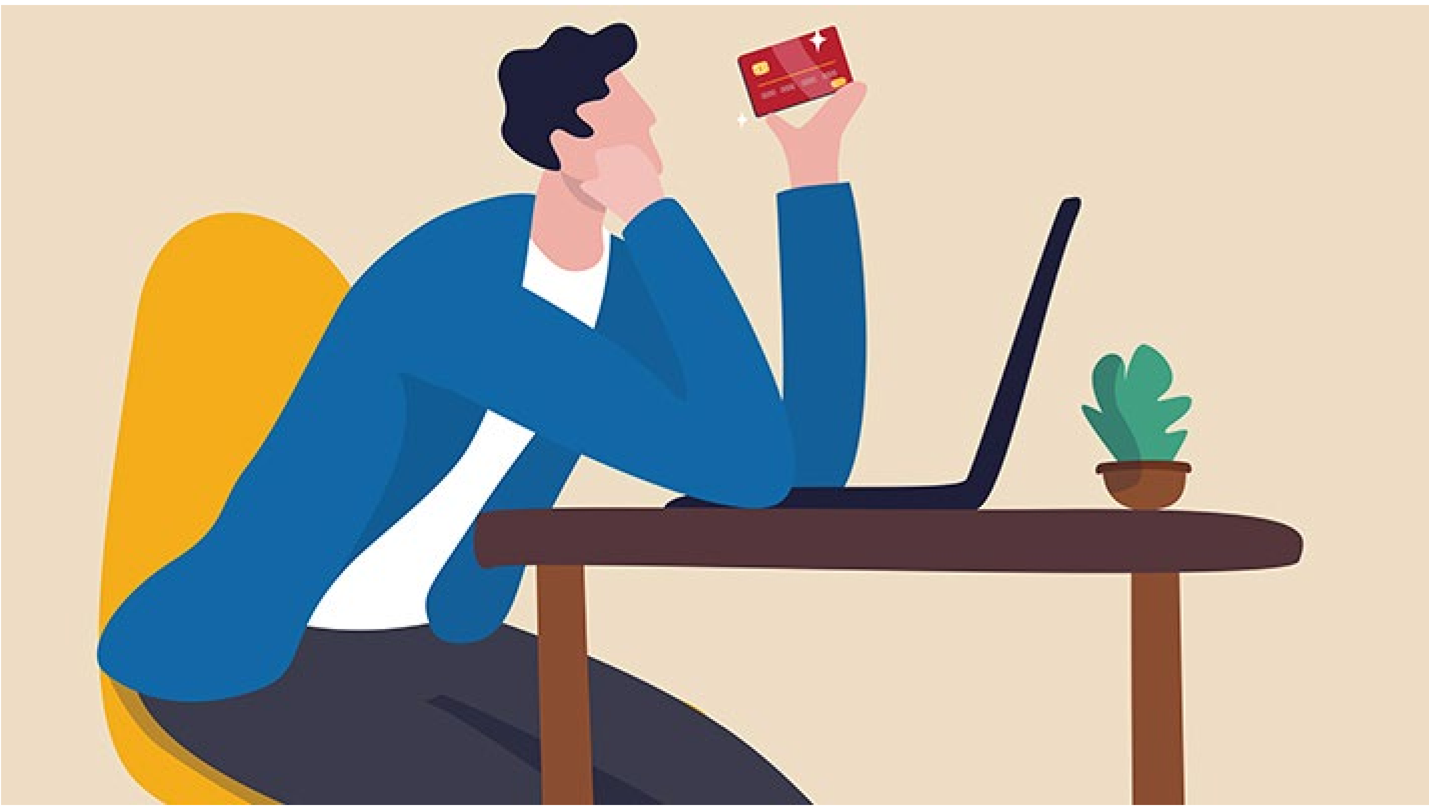
In a perfect world, managing your finances would be simple. You'd buy stocks when the price is low and sell when the price is high. You'd make a budget and stick to it. You'd save enough to enjoy a long, relaxing retirement.

Of course, the world isn't perfect, and plenty of obstacles can stand in the way of financial bliss. In fact, *you* might be one of those obstacles—or, at least, your *cognitive biases* might.

Cognitive biases are thinking errors that can cause you to make bad financial choices. They could make your brain process information incorrectly, skip over important details or distort memories. External factors, such as social influence, also contribute to them.

But there's good news: Once you can recognize your biases, you can improve your financial decision making.

Here are seven ways you might undercut yourself when it comes to money—and how to defeat them.



## 1. You follow the crowd

Your next-door neighbor just bought a new luxury car and now you want one, even though it's beyond your budget and your old sedan is running fine. If you've ever wanted to do something because it seemed like everyone else was doing it, you fell for what psychologists call the **bandwagon effect**.[1]

The bandwagon effect contributes to someone's desire to do what others do. But it doesn't just affect the car you drive, the clothes you wear or the diets you try. It also impacts investing. Whether you're buying tech shares, real estate or a Beanie Baby, bubbles form when the perceived value of something increases dramatically. More and more people want in, pushing the price even higher.

Yet when too many people jump on the proverbial wagon, the bubble pops and the price plummets. (Cryptocurrency, anyone?) Suddenly, you're left with nearly worthless stocks, an underwater home or a closet full of tiny stuffed animals.

### How to handle it

Of course, short of becoming a hermit, these days you can't avoid some social influence. But you can limit how it affects your decision making: Give yourself a **cooling-off period**—whether it's a day or a week—before making any major financial choice. And **question everything**. Research the hot stock or crunch the numbers to see if a luxury car fits your budget. The more facts you have, the more logical your decision can be.

## 2. Your reserves are spent

If you've ever found yourself staring at a grocery store shelf, unsure of what to buy, you've experienced **decision fatigue**. You have many choices to make each day, and as the day goes on, your ability to make them gets worse.

Decision fatigue reached a peak during the pandemic—people had to carefully decide whom to spend time with, whether it was safe to dine inside, and which situations warranted wearing a mask.[2]

This phenomenon affects financial choices in large and small ways. After a long day at work, you might not have the energy to shop for groceries and cook at home. So, you order takeout—even though it's not in your budget.

On a larger scale, when your decision reserves are tapped out, you could make poor investment moves or avoid planning for the future. You might have no idea where to start with the seemingly endless choices in your 401(k), IRA or brokerage account.

This kind of fatigue also has systemic effects. One study examined the decisions loan officers make throughout the day: The officers were likelier to reject applications to restructure loans at lunchtime and the end of the day. Not surprisingly, the loans with rejected applications were less likely to be repaid. Result: Due to decision fatigue, the loan officers ended up costing their bank around $500,000 a month.

### How to handle it

The best way to beat decision fatigue is to **take breaks throughout the day**. You can also **automate some decisions**, such as setting up automatic contributions to your retirement account or transfers to a savings or investment account. A financial advisor can help you make heads and tails of your options.

## 3. You want instant gratification

In an on-demand world, it's easy to get what you want, when you want it. Problem is, while instant gratification feels good in the moment, it can hold you back from getting ahead with your finances or making progress toward goals. In fact, the more you value getting what you want ASAP, the less likely you are to set *meaningful* financial goals.[3]

### How to handle it

If the pursuit of instant gratification causes you to spend too much or not save enough, you can teach yourself to embrace the benefits of delayed gratification. Try **setting a small goal**, such as saving up for something moderately expensive, like a weekend trip. **Create a timeline** for your goal, but keep it short and manageable, such as three months.

Once you've reached your goal, enjoy it. That weekend trip will likely be more relaxing and fun when you know that it took hard work.

## 4. You find math difficult

Some financial concepts, such as compound interest, can be tricky to grasp. But knowing the basics can help you make smarter money choices.

Compound interest can work for or against you. When you're saving, it's your friend—you earn interest on your savings *and* on the interest your savings earned. That can help your money grow exponentially.

But when it comes to debt, compound interest works against you. That's especially true with "revolving" debt like credit cards. If you carry a card balance month to month, the balance—how much you owe—earns interest, and so does *that* interest. That's why you can end up deeper in debt even as you pay down the card.

### How to handle it

Math is tough, but technology is here to help. Online calculators (your retirement account might offer one) can show you how your savings will grow over time, based on when you start investing and how much you save. Your credit card company might have a payoff calculator that shows you the true cost of your debt if you only pay the minimum.

More tech tools at your disposal: **Set up automatic contributions** to savings and investment accounts, and **set bill payment reminders** to avoid interest charges or late fees.

## 5. You're protecting your ego

Sometimes, money is personal. It's embarrassing to admit you made a mistake, such as selling a stock too soon. Thanks to the **regret-repurchase effect**, experts say you're likely to avoid buying a stock you previously sold for a loss—even though you're likely to earn a profit. Feelings of regret can influence your future purchasing decisions.

### How to handle it

**Remind yourself that you're human** and it's OK to make mistakes—*everyone* does. And don't let your past decisions or experiences with a particular investment influence your future choices.

## 6. You've already spent so much

If you've ever refused to walk out of a bad movie, play or concert because you spent money on the ticket, you've fallen victim to the **sunk-cost fallacy**.

The sunk-cost fallacy causes you to keep spending on things that don't serve you or that end up being more expensive than other options. You don't want to waste money, of course. But paradoxically, this bias causes you to waste even more. (This concept is also known as the **Concorde fallacy**, after the highly lauded but financially doomed supersonic jet. Don't remember the Concorde? *Exactly*.)

### How to handle it

Since you can't get your money back, it's usually better to **cut your losses**—abandon pricey projects or leave a terrible film. And to help avoid feelings of guilt or loss, keep a silver lining in your playbook: Once you leave the theater, you have an extra hour in your day to use however you want. Similarly, once you give up on an investment that's losing money fast, you can put your money into something more potentially profitable.

## 7. You want to avoid loss, at any cost

The stock market has been fluctuating wildly lately. Worries about interest rates and inflation—on top of the continuing pandemic and war in Ukraine—have caused some investors to sell their stocks as if their lives depended on it. Those panicky folks experienced the bias of **loss aversion**.[4]

From a psychological perspective, failure affects people more negatively than success does positively. (It's why Hall of Fame athletes often recall their losses more vividly than their wins.)

Loss aversion is rooted in fear. It means you avoid any risks that could potentially bring about a loss, even though those risks could also bring about a substantial gain. It leads to panic selling. It can also cause you to keep your money in a savings account that barely earns interest rather than invest it.

### How to handle it

One way to move past loss aversion is to **think positively**, such as telling yourself that great risk often brings about great rewards. Focus on what you stand to gain from a particular choice rather than what's at stake.

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Once you identify the cognitive biases that affect you most, you can make a plan to work around them. Understand that *your biases are trying to trick you* into making bad financial choices. It's up to you to hack your brain and trick your biases instead.

### What you can do next

Start thinking about your cognitive bias and how to break them. Then take action. For example, set up bill reminders and automatic deposits to a savings or retirement account. Schedule at least one restful break into your day to give yourself a chance to recharge. And if you think you need professional help, consider hiring a financial therapist.

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[1] Kendra Cherry, "Bandwagon Effect as a Cognitive Bias," VeryWellMind, April 28, 2020 (verywellmind.com/what-is-the-bandwagon-effect-2795895)

[2] Stacey Colino, "Decision Fatigue: Why It's So Hard to Make Up Your Mind These Days, and How to Make It Easier," Washington Post, Sept. 22, 2021 (washingtonpost.com/lifestyle/wellness/too-many-choices-decision-fatigue/2021/09/21/2dffce74-1b22-11ec-bcb8-0cb135811007_story.html)

[3] Austin Perlmutter, "The Real Issue With Instant Gratification," Psychology Today, Sept. 14, 2019 (psychologytoday.com/us/blog/the-modern-brain/201909/the-real-issue-instant-gratification)

[4] Shahram Heshmat, "What Is Loss Aversion?," Psychology Today, March 18, 2018 (psychologytoday.com/us/blog/science-choice/201803/what-is-loss-aversion)

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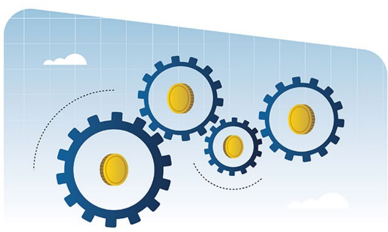

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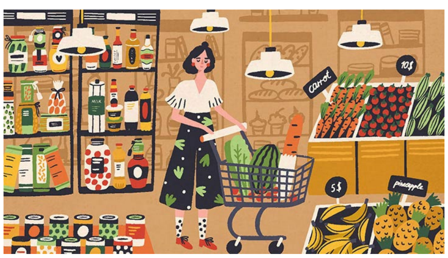

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