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Emotions shape dollars and cents

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Since *The Dallas Morning News* launched its Money Makeover feature two years ago, I've sat in on numerous meetings between financial planners and the readers chosen to participate in the program. The planners ask the standard questions about the person's income, assets and liabilities, and they comb through the reader's financial records.

But the core of the sessions is taken up by questions about the person's life goals, values, fears, hopes and dreams. There's a reason for that. "Money has such a powerful impact on our lives and therefore drives a lot of emotion," said Bryan Clintsman, a certified financial planner at Clintsman Financial Planning in Southlake. "Paying off a mortgage may sometimes not be a smart math calculation, but if it keeps a new widow from losing sleep at night, it might be the right answer."

I've written that all of us have a "money personality" that dictates how we manage our resources. The fast-growing area of behavioral finance aims to quantify how our emotions translate into dollar and cents.

Beyond investing

For example, it uses psychology and finance to try to explain why investors behave the way they do. But it goes beyond investing. Those in the financial services industry are very much aware of how your emotions and human tendencies can affect your view of money and how you manage it, and more are applying such principles in their work.

The topic is the cover story of the current issue of *Investment Advisor* magazine. The title is "All in Your Head: Using Behavioral Finance to Manage Clients and Money." "To me, it's almost something I do at a gut level," said Deb Outlaw, chief financial officer and a certified financial planner at Perryman Financial Advisory in Dallas. "A lot of it comes from being able to read people," she added. "You have to understand who they are and where they're coming from and what will motivate them to take that next step." Sometimes that means not "being their best buddy," she said.

That may mean bluntly telling a debt-ridden client that he or she has to cut back on expenses or get another job to bring in more income. Ultimately, the key advice in that scenario is to quit adding to your debt and focus on paying it off. Then change your spending patterns not only in action but, most important, in your mind.

Good coach

"A good coach will push you over that hurdle, but it may not feel good at the time," Ms. Outlaw said. It's important that you feel comfortable with a financial adviser, so you can be honest with him or her about your financial issues.

"A candid discussion with an adviser can help detect areas of weakness, check unrealistic expectations or counter misperceptions that could be frustrating and costly," said Viktor Szucs, a certified financial planner at Quest Capital Management in Dallas.

Personal bias

One of the things that could come out of the discussion is your personal bias when it comes to investment decisions. One type of bias is what behavioral finance experts call "myopic loss aversion."

"Investors tend to view their investments over short-term horizons," Mr. Szucs said. "Investors also feel the pain of financial loss more acutely than the pleasure of financial gain. That fear of loss breeds excessive caution." Your financial adviser's job is to gauge how much uncertainty you can stomach.

Comfort with risk

"Increasingly, you see people saying one of the most important things is to understand not just what your clients are saying, but are they really going to be comfortable with the risk in the portfolio," said Shiv Mehta, head of asset allocation at ING Investment Management in New York. "It's very easy when the market is going in one direction." But when markets go up and down, that really tests investors' mettle. "That's when you need behavioral finance, because then you really need to separate how people are going to hang in there," Mr. Mehta said.

Then there's the very common tendency among people to invest based on past performance. In a way, you can't blame us, a friend of mine said once: What else do you have to go on? That's what's called "inappropriate extrapolation," which is the tendency to look at recent events or market performance and assume that those events or conditions will continue indefinitely.

"Investing with your eyes in the rear view mirror is a very bad idea, because markets change a lot, and they change in anticipation, not typically in reaction," Mr. Mehta said. "We need to look at history not as a guide but as a pattern." It all goes back to avoiding risk, and you can't blame humans for that. "This is hard-wired into our brains as human beings," Mr. Mehta said. "We underappreciate risk when markets are going up, and we overestimate risk when markets are going down."

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