Book Review - *Why Smart People Make Big Money Mistakes... and How to Correct Them : Lessons from the Life-Changing Science of Behavioural Economics'*

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Executive Summary- *'Why Smart People Make Big Money Mistakes... and How to Correct Them : Lessons from the Life-Changing Science of Behavioural Economics' is a book that concentrates on the emotional and behavioural aspects of personal finance. The book touches upon topics like herd mentality, loss aversion, lack of attention to numbers, confirmation bias and overconfidence which impact personal finance negatively. The authors stress on the fact that emotions and behavioural mistakes have to be kept in check while making money decisions.*

The book, ***'Why Smart People Make Big Money Mistakes... and How to Correct Them : Lessons from the Life-Changing Science of Behavioral Economics'*** is written by Gary Belsky and Thomas Gilovich. It was first published in 2010.

Personal finance is all about money and numbers. Even then people bring emotional and behavioural aspects to it. This book focuses on the behavioural mistakes that people make even though they are good at numbers and analysis. These mistakes cause problems in their financial planning. The authors lists down the common behavioural mistakes and give some guidance on how to overcome them-

1) Not all dollars are created equal -

People fall into the psychological trap that money earned by hard work is different from money earned via gifts or money being spent is different from money lost without actually giving it away. For example, many people gamble away unexpectedly earned money thinking it is anyways an extra income.

It can be avoided by having a rule that you will not spend any money received till after three months are gone.

2) Loss Aversion and Sunk Cost Fallacy -

People take on more risk to avoid loss as compared to risk taken to earn money as everyone hates losing. People also fall for the sunk cost fallacy. For example, a person has made an investment which is unfortunately not doing well. Instead of selling it off, and restricting the loss, he holds on to the investment hoping against hope that it will make a turnaround. This decision will end up in a bigger loss as the investment's value will keep eroding over a period of time.

It can be avoided by thinking rationally. One should also understand one's risk tolerance and risk appetite before investing so that one knows how much loss is acceptable financially and emotionally.

3) Indecision - When a person gets many choices, chances are the decision is never made or delayed. If there are 3 options to choose from, people tend to choose the one that is midway between the other two irrespective of whether it is suitable for them. He gives an example of Fred having a stock bought at a price of $1000. It drops to $700. Another person, Wilma had a different stock, but sold that and purchased this stock at $1000. The value drops to $700. Most people think Wilma would be more sad even though the financial loss is the same. She will be more unhappy compared to Fred as there is pain in regret of taking the wrong decision. This can affect investments.

Avoid indecision by taking firm steps as per deadlines. It might be better to start SIPs in mutual funds instead of making difficult buy decisions every now and then.

4) Number Numbness - People tend to ignore important aspects like inflation, probability and small numbers. For example a person will ignore the probability aspect of returns while choosing where to invest. Investing mutual funds, ULIP products involves expenses like management fees. It will be unwise to ignore them while deciding which product to invest in thinking it is a small number.

It helps to be more aware while making investment decisions. We know the magic of compounding. It is better to invest Rs.1000 every month as a 21 year old rather than investing Rs. 5000 per month when you are 30 years old. You lose the advantage of money working for your for 9 years.

It can be avoided by understanding the fine print before buying investment products. You have to gain knowledge regarding inflation, returns potential, financial planning and how economic conditions can affect your investments.

5) Confirmation bias and Anchoring - Confirmation bias is a behaviour characterised by looking for affirmation for one's decisions. For example, if I decide that I will invest in Infosys, I will look for articles confirming why buying shares of Infosys is a good idea. It is rare a person checks for negative aspects of a decision already made. Anchoring means clinging to one idea or decision without too much rational thought.

You can overcome it by broadening your knowledge, interacting with different people and check before taking a decision. You also need to be humble enough to accept that you can make a mistake.

6) Overconfidence in one's capabilities

Some of us think of ourselves as financial whiz kids and are overconfident of our investing capability. It is important to keep a check on this and make informed investment decisions. We can see it in our daily lives that we do not always complete our tasks on time as decided as to what is to be done. Entrepreneurship is a tough route to take but still many join the bandwagon and a large number fail.

It is better if you question your investment decision before executing it. You might be all fired up to fulfil your New Year resolution of exercising every morning. But it might be better to take a 3 month membership in an affordable gym and then extend it only if you are sticking to your resolution rather than buying a 1 year membership in a fancy gym.

7) Belief in the grapevine and Herd Mentality – We want to follow others for conformity. We feel that if everyone is doing one thing, it must be right and go ahead and do the same thing. For example, if you have a blue chip stock whose price has been falling in a volatile market, you will want to sell it as everyone recommends to sell it. You are not sure of the reasons but jus follow the herd.

You should follow value investing. You should make informed investment decisions and be patient. Long term investments will face volatility in the short-term. This is not a reason to sell your investments the minute they start falling in value.

Conclusion

The authors say that a human brain thinks reflexively and reflectively. Reflex thinking is unconscious where fear, greed and other emotions come into play. Unnecessary shopping when you are sad, holding on to investments even after the target sell price is reached are examples of reflex thinking. Reflective thinking is deliberate thinking with analysis. It is important to use reflective thinking while making money decisions. You can train your brain into reflective thinking by

- Listing down pros and cons,
- Waiting before making a financial decision and
- Predicting different outcomes and propositions and looking at them in positive and negative ways.

The book is a good read for people who are beginners in personal finance planning. It talks about typical investor behaviour that one can fall into. New and Experienced people can use it for reference while making financial decisions.

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