

## How Behavioral Finance Can Improve Your Financial Decisions

Behavioral finance helps uncover how our hidden blind spots can impact financial decisions, from spending habits to investment choices. These blind spots are systematic errors in thinking that lead to flawed judgments and decisions. They may arise from emotional influences, such as fear or regret, or when we fail to properly recall or interpret information. Since blind spots affect everyone, recognizing them is the first step for improving decision-making.

Companies are increasingly applying behavioral finance principles to create products and strategies that benefit consumers by helping them reduce the influence of blind spots. In the following sections, you'll find examples from everyday life that demonstrate how behavioral finance can help you save more for retirement, avoid excessive credit card fees, and optimize your investment portfolio.

### Behavioral Finance Helps People Save More for Their Retirement

As we live longer, we spend more time in retirement. However, many blind spots can interfere with saving adequately. First, determining exactly how much to save for retirement is a difficult question to answer—it requires knowing how long we will live, forecasting future income, predicting investment growth, etc. Even if we knew the right amount to save each month, many people struggle to stick to their plan. This is due to *present bias*, where we prefer today's consumption over saving for the future.

The Save More Tomorrow (SMarT) program—designed by Nobel Prize-winning economist Richard Thaler—encourages workers to save by committing in advance to allocate a portion of their future income raises toward retirement savings. The program has two key features:

1. **Contribution increases align with pay raises:** The increased contribution is deducted from future raises, so it doesn't reduce current take-home pay. By framing the increase as a reduction in future gains, rather than a loss today, it minimizes *loss aversion*, which is the tendency to feel the pain of losses more deeply than the pleasure of financial gains.
2. **Automatic increases in contributions:** Contributions continue to increase until they reach a default maximum, addressing the *status quo bias* by preventing people from sticking with an initially low contribution rate.

In the original implementation, 57% of the employees at a company enrolled in the SMarT program. The results were impressive: the average savings rate among participants rose

from 3.6% to 13.6% over five years, while the savings rate of employees who opted out remained around 6.5%.

(Source: Thaler, R. H., & Benartzi, S. (2004). *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*. *Journal of Political Economy*)

### **Behavioral Finance Help People Avoid Credit Card Fee and Improve Their Credit Score**

Because of the tendency to favor immediate gratification at the expense of long-term cost (*self-control* blind spot), customers often end up spending a lot on their credit cards and paying high interest by making only the minimum monthly required payment. Financial institutions leverage behavioral finance principles to help people save money by:

- nudging cardholders to break larger purchases into fixed and more manageable monthly installments, by comparing it to the cost of paying the balance slowly and accruing interest.
- providing real-time alerts about changes to users' credit reports. Instant feedback reduces late fees and prevents missed payments or running up large balances.

According to one bank, 90% of its users have seen their credit scores increase after using these tools, which can directly translate to lower interest rates, reduced late fees, and fewer penalties on their credit cards.

### **Behavioral Finance Improves Portfolio Investments**

Many investors fail to rebalance their portfolios over time and tend to stick with the current situation even if it's not optimal (*Status quo* blind spot). To consider investor's time horizon and risk tolerance, some companies automatically adjust the asset allocation of a portfolio based on the investor's expected retirement year. They gradually shift from aggressive, stock-heavy allocations to more conservative, bond-heavy allocations as people approach retirement. Automatic rebalancing is also useful for the type of investors who focus on short-term gains or losses and may be prone to emotional trading decisions that can harm portfolio returns. Reducing the need for frequent portfolio changes encourages patience and long-term thinking, helping investors avoid the potential fees and losses associated with frequent trading.

Another common blind spot is *loss aversion*: investors hold on to their losing stocks for too long because they are reluctant to sell them and realize a loss. To balance the effect of loss aversion, some financial institutions encourage the use of tax-loss harvesting strategies, encouraging investors to sell losing positions strategically to offset gains and reduce tax liabilities.

Want to learn more about your blind spots? Our Financial Virtues® survey offers a comprehensive assessment of 18 financial decision-making blind spots, among the most studied in finance. You'll gain insights into potential blind spots and how they might influence your financial choices.