New Insights in Financial Planning From Behavioral and Causal Economics

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Financial planning professionals continuously seek ways to incorporate new insights into their strategies to assist clients. Behavioral economics has become of particular interest to financial planners, because it helps explain the biases people face in real world investment decisions. Behavioral economics better explains human behavior than the traditional model of economic decision making—expected utility—which suggests that people are 100% rational.

Being aware of such biases can help clients better manage their natural emotions and stay on track with plans that best serve their long-term interests and those of their family. But, behavioral economics, in its mainstream form, is loose and difficult to consistently apply. That's because it essentially mashes together a structural analytical framework—cumulative prospect theory—with a separate laundry list of psychological biases. In applying the insights of behavioral economics, planners generally find themselves educating clients on one-off biases, with no underlying glue to hold them together. Cumulative prospect theory is built on short-term 'lottery' type outcomes, which reinforces a 'casino' mentality, exactly the opposite thinking of that desired in financial planning.

That's why there's growing interest in the financial planning community in a particular new stream of behavioral economics, known as causal economics. Causal economics provides a consistent way of thinking about investing that keeps the focus on achieving rational results and managing our biases on the journey to get there. Causal economics is constructed exactly the way financial planners want people to think about investing—deliberate upfront investment/effort is required in anticipation of expected future returns.

Table 1 puts this difference into perspective:

Table 1: Comparison of Models

	Rational / Irrational	**Outcomes**	**Time Horizon**
Neoclassical Economics / Expected Utility	100% Rational	Random lottery outcomes	Short-term (one period) only
Behavioral Economics / Cumulative Prospect Theory	Rational & Irrational	Random lottery outcomes	Short-term (one period) only
Causal Economics	Rational & Irrational	Upfront deliberate cost/effort precedes future expected benefits	Extended time horizons

Real world decisions, from weight loss, to finding a mate, to investing, reflect this reality of deliberate upfront cost/effort required for expected long-term benefits. In causal economics this is formally known as the principle of causal coupling.

As a financial planner, reinforcing the central concept of causal coupling keeps clients focused on the long-term and the reality that they have to take action today and ongoing, while keeping their biases in check. Keep coming back to this principle to keep them focused.

Educating your clients on the most pervasive biases that can impact investing can help keep them on track. All of these biases are grounded in psychology, often associated with behavioral economics, but causal economics actually builds them into the core framework, so you can be more confident how they connect to the core of investing behavior—causal coupling.

Behavioral economics and causal economics both provide great insight into loss aversion and the impact on investing behaviors. Specifically, they demonstrate that investors are usually enticed by unrealistic long-shot gains, overly worried about unlikely losses, and sell in a panic during market crashes. Risk attitudes get a lot of attention in behavioral economics, but causal economics also introduces the importance of cost aversion. It’s not only the fear of risk that can immobilize investment decisions. Just as important are known, upfront and deliberate costs. Based on an endowment effect, cost aversion can result in people avoiding important upfront costs in investing and as a result foregoing the potential long-term benefit they are truly after.

Without awareness, education and management, the psychological principle of hyperbolic discounting can also stall financial plans. That’s because it results in the future not being given enough attention relative to present needs. Of course financial planners need to keep the future very front and center in the customer mindset.

The explicit time element of causal economics deeply grounds a number of bias principles that can unfortunately reinforce the dangerous mindset that future results are expected to be like current/past results. These principles include cognitive dissonance, status quo bias, recency and selective perception just to name a few. Not being aware of them and failing to manage them can be disastrous to staying the course on a financial plan. If you’re interested in a massive list of behavioral finance biases that you can connect back to the underlying framework of causal economics, visit http://www.psyfitec.com/p/the-big-list-of-behavioral-biases.html.

In financial planning, it’s vital to stay abreast of the latest relevant thinking in a constantly changing world. Behavioral economics and causal economics fit into that category. Clients can get off track for many reasons. Don’t let it be the result of a fundamental misunderstanding of the nature of investing and bias behaviors that they could better manage through education and attention. This is perhaps some of the strongest value a financial planner can provide to their clients over time.

For more insights on causal economics, visit www.causaleconomics.com.