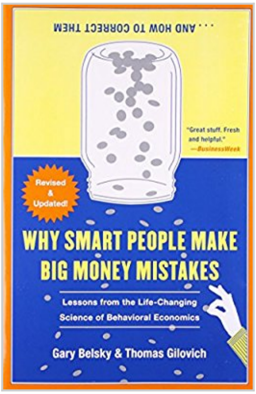

Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons from the Life-Changing Science of Behavioral Economics

By Gary Belsky, Thomas Gilovich

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Protect and grow your finances with help from this definitive and practical guide to behavioral economics—revised and updated to reflect new economic realities.

In their fascinating investigation of the ways we handle money, Gary Belsky and Thomas Gilovich reveal the psychological forces—the patterns of thinking and decision making—behind seemingly irrational behavior. They explain why so many otherwise savvy people make foolish financial choices: why investors are too quick to sell winning stocks and too slow to sell losing shares, why home sellers leave money on the table and home buyers don't get the biggest bang for their buck, why borrowers pay too much credit card interest and savers can't sock away as much as they'd like, and why so many of us can't control our spending. Focusing on the decisions we make every day, Belsky and Gilovich provide invaluable guidance for avoiding the financial faux pas that can cost thousands of dollars each year.

Filled with fresh insight; practical advice; and lively, illustrative anecdotes, this book gives you the tools you need to harness the powerful science of behavioral economics in any financial environment.

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Editorial Review

Review
"A terrific introduction to the emerging science of behavioral finance." **-- *Money* magazine**

"Great stuff. Fresh and helpful." ***-- BusinessWeek***

"This very helpful book is aimed at the novice and the expert, and you come away from it somewhat chastened by your own financial mistakes, but hopeful that you might learn a thing or two about holding onto your hard-earned cash. The authors don't offer simplistic solutions, but hard facts and sound advice."

--Robert J. Hughes, *SmartMoney*

About the Author
Gary Belsky is editor in chief of *ESPN The Magazine*, where he has worked since 1998. The author of several books, he lectures frequently on the psychology of decision-making to business and consumer groups around the world. From 1994 through 1998, Belsky was a regular commentator on CNN's *Your Money* and a frequent contributor to *Good Morning America*, *CBS This Morning*, *Crossfire* and *Oprah*; he continues to appear on local and national radio and TV, commenting on sports, economics, business and personal finance. A St. Louis native, Belsky graduated from the University of Missouri in that city in 1983 with a BA in speech communication and political science. Before joining *ESPN* he was a writer at *Money* magazine and a reporter for *Crain's New York Business* and the *St. Louis Business Journal*. In 1990, Belsky won the Gerald Loeb Award for Distinguished Business and Financial Journalism, administered by The Anderson School at UCLA. Belsky, who lives in Manhattan, serves on the board of directors of Urban Pathways, one of New York City's largest providers of services to the homeless and mentally ill; as well as the New York Neo-Futurists, an East Village theater company.

Thomas Gilovich is a professor of psychology at Cornell University and author of *The Wisest One in the Room* (with Lee Ross), *How We Know What Isn't So*, *Why Smart People Make Big Money Mistakes*, and *Social Psychology*. He lives in Ithaca, New York.

CHAPTER 1

NOT ALL DOLLARS ARE CREATED EQUAL

> By the third day of their honeymoon in Las Vegas, the newlyweds had lost their $1,000 gambling allowance. That night in bed, the groom noticed a glowing object on the dresser. Upon closer inspection, he realized it was a $5 chip they had saved as a souvenir. Strangely, the number 17 was flashing on the chip's face. Taking this as an omen, he donned his green bathrobe and rushed down to the roulette tables, where he placed the $5 chip on the square marked 17. Sure enough, the ball hit 17 and the 35-1 bet paid $175. He let his winnings ride, and once again the little ball landed on 17, paying $6,125. And so it went, until the lucky groom was about to wager $7.5 million. Unfortunately the floor manager intervened, claiming

that the casino didn't have the money to pay should 17 hit again. Undaunted, the groom taxied to a better-financed casino downtown. Once again he bet it all on 17 -- and once again it hit, paying more than $262 million. Ecstatic, he let his millions ride -- only to lose it all when the ball fell on 18. Broke and dejected, the groom walked the several miles back to his hotel.

"Where were you?" asked his bride as he entered their room.

"Playing roulette."

"How did you do?"

"Not bad. I lost five dollars."

This story -- told in some parts of Nevada as the gospel truth -- has the distinction of being the only roulette joke we know that deals with a bedrock principle of behavioral economics. Indeed, depending on whether or not you agree with our groom's accounting of his evening's adventure, you might have an inkling as to why we considered a different title for this chapter, something like "Why Casinos Always Make Money." The conventional answer to that question -- that casinos are consistently profitable because the odds for every game are stacked in favor of management -- does not tell the whole story. Another reason casinos always make money is that too many people think like our newlywed: because he started his evening with just $5, he felt his loss was limited to that amount.

This view holds that his gambling spree winnings were somehow not real money -- or not his money, in any event -- and so his losses were not real losses. No matter that had the groom left the casino after his penultimate bet, he could have walked across the street and bought a brand-new Rolls-Royce for every behavioral economist in the country -- and had enough left over to remain a multimillionaire. The happy salesman at the twenty-four-hour dealership -- this is a Vegas story, after all -- would never have thought to ask if the $262 million actually belonged to the groom. Of course it did. But the groom never really saw it that way. Like millions of amateur gamblers, he viewed his winnings as an entirely different kind of money and was therefore more willing to make extravagant bets with it. In casino-speak this is called playing with "house money." The tendency of most gamblers to fall prey to this illusion is why casinos would likely make out like bandits even if the odds were stacked less heavily in their favor.

The "Legend of the Man in the Green Bathrobe" -- as the above tale is known -- illustrates a concept that behavioral economists call "mental accounting." This idea, developed and championed by the University of Chicago's Richard Thaler, underlies one of the most common and costly money mistakes -- the tendency to value some dollars less than others and thus to waste them. More formally, mental accounting refers to the inclination to categorize and treat money differently depending on where it comes from, where it is kept, or how it is spent. To understand how natural, and tricky, this habit can be, consider the following pair of scenarios. Here, as in similar mental exercises you'll find sprinkled throughout this book, try as best as you can to answer each question as realistically as possible. The more "honest" your responses, the more you'll learn about yourself.

Imagine that you've bought a ticket to the Super Bowl or a hit Broadway play. At the stadium or theater you realize you've lost your ticket, which cost $150. Do you spend another $150 to see the game or performance?

Now imagine the same scenario, but you're planning to buy the $150 ticket when you arrive. At the box office, you realize you've lost $150 somewhere in the parking lot. Still, you have more than enough in your wallet to buy the ticket. Do you?

If you're like most people, you probably answered "no" to the first question and "yes" to the second, even though both scenarios present the same dilemma: a loss of $150 and the subsequent prospect of spending another $150 to be entertained. The reason for this seeming inconsistency is that for most people the first scenario somehow translates into a total entertainment cost of $300 -- two actual tickets, each costing $150. This might be too much, even for a Super Bowl or hit play. Conversely, for most people the loss of $150 in cash and the $150 cost of the ticket are somehow separated -- mentally -- into two independent categories or accounts. They are unfortunate but unrelated. This type of thinking -- treating two essentially equal $150 losses in very different ways because they occur in different manners -- is a classic example of mental accounting.

The notion of mental accounts is anathema to traditional economics, which holds that wealth in general, and money in particular, should be "fungible." Fungibility, at its essence, means that $100 in roulette winnings, $100 in salary, and a $100 tax refund should have the same significance and value to you, since each Benjamin (as the kids like to say) could buy the same number of Happy Meals at McDonald's. Likewise, $100 kept under the mattress should invoke the same feelings or sense of wealth as $100 in a bank account or $100 in U.S. Treasury securities (ignoring the fact that money in the bank, or in T-bills, is safer than cash under the bed). If money and wealth are fungible, there should be no difference in the way we spend gambling winnings or salary. Every financial decision should result from a rational calculation of its effect on our overall wealth.

If only this were the case. In reality, as you probably have noticed, people are not computers. They lack the computational power and the strength of will necessary to manage all their finances on a consolidated balance sheet. It would be intellectually difficult, and emotionally taxing, to calculate the cost of every short-term transaction (buying a new compact disc, for instance, or going to a movie) against the size of every long-term goal or need (planning for retirement or saving for college). So to cope with this daunting organizational task, people separate their money into mental accounts, necessarily treating a dollar in one account differently from a dollar in another, since each account has a different significance. A vacation allowance, for instance, is presumably treated with less gravitas than the same amount of money socked away in an Individual Retirement Account.

But what's wrong with that? The average person, more self-aware, perhaps, than the average economist, knows that he or she is not as smart or as iron willed as economists maintain. And that's why people set up mental accounts in the first place. Thus, rather than being illogical or irrational, the ability to corral money into different mental accounts often has beneficial effects. Most important, perhaps, it allows you to save effectively for future goals. After all, "house money" for many Americans is not casino winnings, but the money they manage to squirrel away for a down payment on their dream home. Even profligate spenders manage to avoid tapping into these savings, often for no other reason than that they've placed it in a sacred mental vault. Certainly mental accounting is not always effective, given the problems human beings have with self-control. That's one of the reasons certain tax-deferred retirement accounts such as IRAs or Keogh plans penalize early withdrawals, and it is why they enjoy such popular support. And that is why, when attempting to balance and evaluate their investment portfolio, people often err by failing to knock down mental walls among accounts. As a result, their true portfolio mix -- the combination of stocks, bonds, real estate, mutual funds, and the like -- is often not what they think, and their investment performance often suffers.

In any event, the sometimes useful habit of treating one dollar differently from another has a dark side as well, with consequences far more significant than simply increasing your willingness to make risky bets at roulette tables. By assigning relative values to different moneys that in absolute terms have the same buying power, you run the risk of being too quick to spend, too slow to save, or too conservative when you invest -- all of which can cost you money. We'll get to all of that shortly, but the easiest-to-explain instance of mental accounting's harmful effects is the different value people place on earned income as opposed to gift income. That is, we'll spend $50 from Mom (or $50 we find in the street) with less thought than $50 we've earned on the job. Still, while such distinctions may be illogical from a strict economic point of view, they seem reasonable and harmless enough. After all, gift money -- or casino winnings, for that matter -- is generally "found" money. You didn't have it one second before you got it, so what's the harm in not having it again?

True enough. More troubling, though, and potentially more costly, is the tendency people have to "deposit" money in certain mental accounts when that money is actually part of another. Consider tax refunds, for example. Many people categorize such payments from the government as found money -- and spend it accordingly -- even though a refund is nothing more than a deferred payment of salary. Forced savings, if you will. If, on the other hand, those same people had taken that money out of their paycheck during the course of the previous year and deposited it into a bank account o...

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