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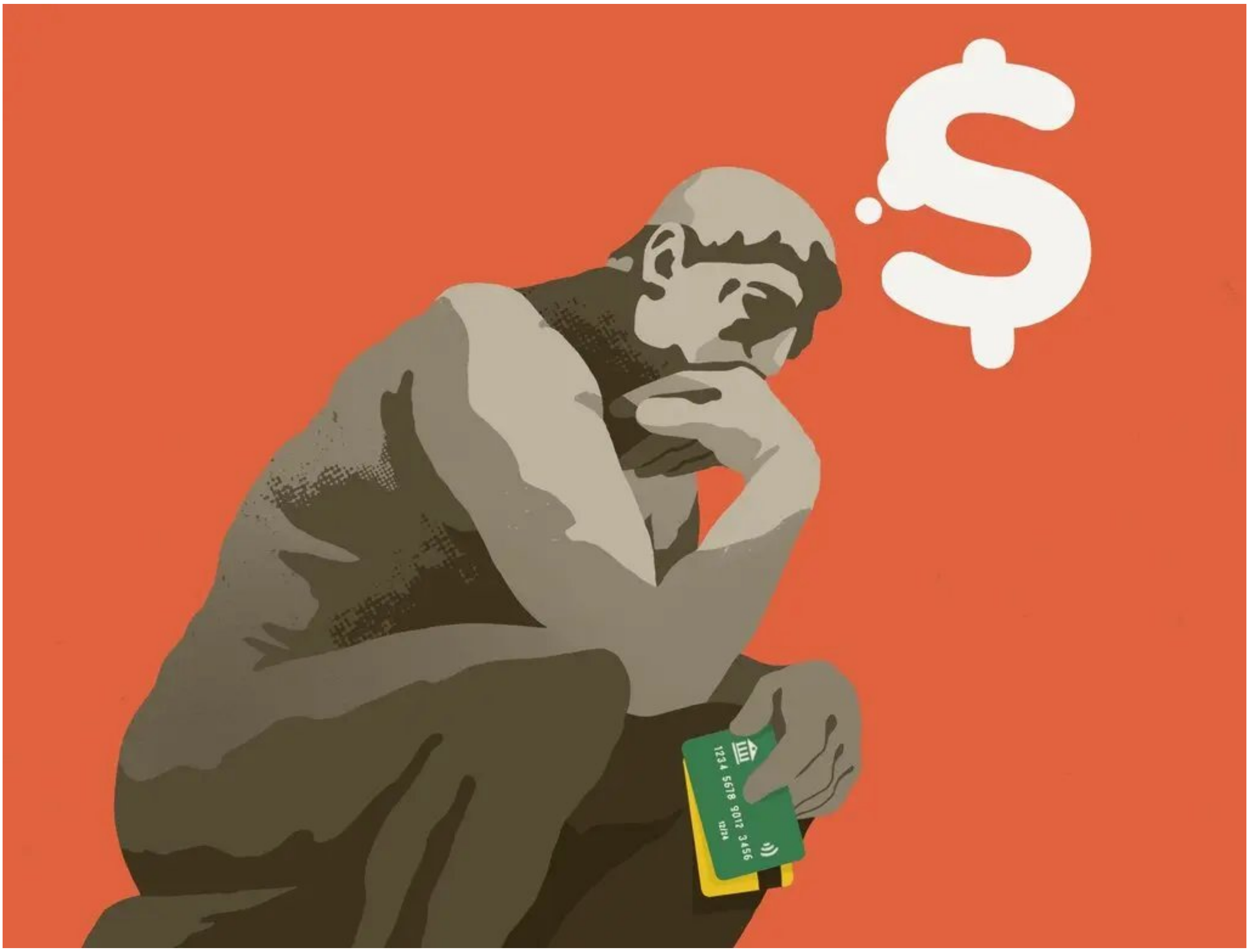
RETIRING

When It Comes to Money, Your Brain Can Be Your Own Worst Enemy

Our cognitive biases can get in the way of saving for the future, especially for retirement. Here's how to recognize and overcome them.



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By Kristin Wong

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Sara Fernandes was 26 when she got her first credit card.

"It felt like free money," Ms. Fernandes said. "Like suddenly I could buy stuff and not worry about paying for it. That's where my mind was at."

She and her husband used the cards to pay for restaurant meals, nice clothes and European vacations. When a statement arrived, they would pay the minimum and keep spending. "We threw the most epic Christmas parties for our family. Our kids always had everything they asked for," she said. "It was an amazing life, I'm not going to lie."

Over the next 13 years, she and her husband amassed $20,000 worth of credit card debt. They started using the cards to cover basic living expenses, and eventually some of the cards were maxed out.

"I remember going to the supermarket and none of my cards worked and I had to leave the groceries there," Ms. Fernandes, 50, said. "I was mortified and confused." That's when she went home and took a closer look at her statements. "We were hardly making a dent" in the balance, she said, because her interest rate was high.

With the average credit card interest rate at nearly 24 percent, according to LendingTree, it's expensive to stay in debt. Yet 29 percent of credit card customers pay only the minimum or close to it, even when they can afford to pay more, according to data from the National Bureau of Economic Research. It doesn't make mathematical sense, but one explanation for this tendency, experts say, is a form of cognitive bias called anchoring. A term borrowed from behavioral economics, the anchoring effect describes our tendency to over-rely on a piece of information presented to us. For example, when a credit card statement suggests a minimum payment of $25, that amount becomes an anchor, guiding people on how much to pay each month.

We like to think that good financial habits are simple — crunch some numbers, create a budget and stick to it. But if being good with money were that easy, we'd all be good with money. Many of our financial struggles have more to do with psychology and behavior. And several kinds of cognitive biases can keep us from making smart financial moves.

The Here and Now

If present bias could be summed up in a single word, that word might be

“YOLO.” This bias describes our tendency to overvalue the present, often at the expense of the future. Research, including a study from the University of Rhode Island published in 2019, suggests that present bias poses significant challenges to saving money. Unsurprisingly, it often leads to overspending.

An awareness of the bias might help counteract it, said James Choi, a professor of finance at the Yale School of Management. In a study on early-withdrawal penalties, Dr. Choi and his colleagues tested this idea. They gave people money that they could deposit in two different accounts. One allowed them to withdraw the money whenever they wanted. The other, which the researchers called a “commitment account,” came with early-withdrawal penalties of either 10 or 20 percent. In some cases, participants couldn’t withdraw the money early at all.

Dr. Choi and his team found that when both accounts paid the same interest rate, people deposited more money into the commitment account. In other words, people might have known that their future selves would be tempted to take out the money, so they chose the account that would penalize them for doing so.

“It seems to suggest that people were aware of their present bias and made a decision to counteract it,” Dr. Choi said. Since most individual retirement accounts and 401(k)s come with early-withdrawal penalties, a retirement account may be an ideal vehicle for avoiding this bias.

Same Old

Status quo bias explains our reluctance to change. We prefer our current state of existence, so doing anything that might disrupt it — from paying off debt to rebalancing an investment portfolio — feels daunting and uncomfortable. A classic study found that status quo bias can even influence our choices about retirement plans and health care plans at work.

Status quo bias can make it hard to build good financial habits because we assume we’ll have to make significant changes in order to do so.

“Whenever someone’s going to make a financial change, they imagine this spartan lifestyle,” said Madison Sharick, a certified financial planner in Pittsburgh. “You cancel all your subscriptions. You’re eating ramen noodles. You don’t go on vacation ever. I think that’s often what we picture when we say that we’re going to make a financial change, but it doesn’t have to be like that."

Instead, start small. For example, when Ms. Fernandes realized her debt was compounding, she came up with a plan to pay it off over time and curb her spending. "I needed a budget to know exactly how much we were making and how much we were spending and where exactly it was going," she said.

To build savings, Ms. Sharick recommended automating as much as possible. For example, automatic escalation is a common feature in 401(k) plans that increases contributions over time, so you can bump up the amount you want to invest.

"It's the path of least resistance," she said. "It's going to invest more for you each year, but you don't have to go in and make changes."

Blinded by the Bright Side

When we think about the future, we tend to assume it will be better than the present. The neuroscientist Tali Sharot called this tendency the optimism bias, describing it as a habit of overestimating the likelihood of positive events and underestimating the likelihood of negative ones. Like present bias, this tendency can cause people to procrastinate on financial goals. A 2014 study suggested that people save less money when they assume the future will be optimistic. But when they were instructed to think that "the future will be exactly like the present," their savings rates increased.

"I can tell you for sure that this study is absolutely true," Ms. Sharick said. Many of the clients she has worked with, even those approaching retirement, neglect saving because they assume they'll be in a better position to do so later. "They think they're eventually going to come into money and their issues will solve themselves," she said.

A practice of gratitude could be a relatively easy way to curb optimism bias. It forces the mind to focus on the present.

"Once I started feeling grateful for where we were — yes, it was bad financially, but we had jobs and we were healthy — that's when I started seeing the debt going down," Ms. Fernandes said. "We started making more money, we started to trust the process, and we kept working."

It might be especially easy to fall into this way of thinking during an economic downturn — we can only hope the future will be better. (In fact, both Dr. Choi and Ms. Sharick said a recession could make any of these biases worse, as we're more prone to fall for them when we're under financial stress.) But even if our optimism holds true, it shouldn't keep us from building good financial habits in the present.

Following the Crowd

You've heard of keeping up with the Joneses — it's the bandwagon effect, which describes our tendency to make decisions based on what we see others doing. It's what Ms. Fernandes found herself doing when she accumulated credit card debt.

"Everybody we knew had credit cards, and nobody was worried about paying them off," she said. "I saw my friends buying everything they wanted, and I wanted to fit in and do the same."

A 2015 study found that the bandwagon effect makes people spend more on luxury goods. When you see everyone in your neighborhood driving a Tesla, it's easy to think maybe you also need a Tesla.

Ms. Sharick said that one way to counteract this problem was to limit your time on social media.

"When you get a sense that everyone else is going on vacation or popping expensive bottles of champagne, it makes it seem like these things are normal," she said. These images often encourage spending. "One thing nobody is ever posting on social media is how they weren't able to pay off their whole credit card bill or if they had to go into debt to do those things," Ms. Sharick added.

In general, humans have a tendency to consider what others are doing in order to make their own decisions — even if it doesn't lead to jumping on the bandwagon. For example, in another 2015 study, people who weren't saving very much in their 401(k)s were told how much their peers were saving. When they discovered that their peers were saving more money than they were, it further decreased their savings amounts.

"I think that there are several things that happen when you observe what your peers are doing," said Dr. Choi, a co-author of the study. "If you feel like you're so far behind your peers in a particular domain, one response could be that you're going to work hard to catch up. Another response is that you just get discouraged and disengage."

Sometimes financial transparency can be helpful, but knowing what our peers are doing can often distract from our own financial progress. To stay the course, Dr. Choi said, families need a financial purpose.

"Having a financial plan seems to be associated with a lot better financial outcomes," he said. This starts with a basic budget, but it helps to set a goal, like getting out of debt so you can save up for a family vacation. When you have something meaningful to work toward, it's easier to counteract this bias.

Latching On

The anchoring effect describes our tendency to latch on to the most recent information presented to us.

The psychologists Daniel Kahneman and Amos Tversky illustrated this tendency in a well-known study. Participants were asked what percentage of African countries belonged to the United Nations, and their answers varied depending on a random number they were given before being asked the question.

In the real world, anchoring often shows up in negotiations. For example, if you're negotiating a starting salary of $90,000 but your prospective employer throws out a much lower number, you might subconsciously anchor to that number and counter with a lower salary than you originally planned.

A 2022 study found that anchoring can influence people's decisions when selecting financial products, too. The study also suggested that financial education might help counteract this bias.

"Data also showed the role of financial literacy in modulating attention, as poorly financially literate subjects are more prone to anchoring bias," the study concluded.

If awareness is the first step in combating these biases, perhaps financial literacy is the next. Ms. Fernandes credits financial education for helping her to pay off her own debt and now writes a blog in which she uses her story to help others learn about money.

"There's so much information out there," she said. "Financial literacy is a must."