



Deal or No Deal? Rational vs. Emotional Decisions

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OK. You're the Contestant. There are four suitcases left: \$500,000, \$250,000, \$10,000 and \$100. The Banker offers you \$165,000. Deal or No Deal?

Rationally, you shouldn't accept any offer less than \$190,025, the average of the money in all four briefcases. But, \$165,000 could buy a lot of things. What should you do?

We know that if each contestant took out their pocket calculator, did the math and responded like a robot, Deal or No Deal would be a thoroughly rational game and extremely boring. The game is so popular because it mirrors real life. The vast majority of contestants don't make decisions based on the math. Emotions are every bit as important.

There have been a number of excellent books in the last few years on rational and irrational (aka emotional) behavior. Malcolm Gladwell's [Blink](#), Dan Ariely's [Predictably Irrational](#), and Ori and Rom Brafman's [Sway](#). Just recently, another good one was published. It's called [How We Decide](#), written by Jonah Lehrer, an excellent young writer.

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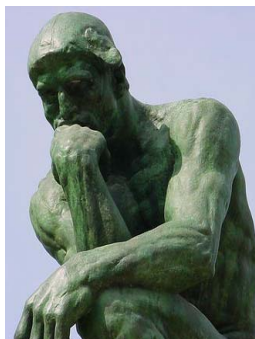
May 28, 2009

Charleston, SC Breakfast Briefing:
"Has the Economy Hit Bottom Yet?"

More details to follow soon.



All four books explore the way people struggle with the rational and emotional issues in making financial decisions. Now, as scientists break open the mind's black box with the latest tools of neuroscience, they're discovering it's not all rational or all emotional. Jonah Lehrer shows us that our best decisions are a finely tuned blend of both feeling and reason. Fascinating reading.



Plato was one of the first to try to explain the mystery of how we make decisions. Lehrer indicates that Plato "liked to imagine the mind as a chariot pulled by two horses. The rational brain, the charioteer, holds the reins and decides where the horses run. If they (the emotional side) get out of control, the charioteer just needs to take out his whip to reassert authority."

Rene Descartes, Francis Bacon, Thomas Jefferson and many others have called for "men" to live by "reason" alone. But these classical theories are built on a crucial mistake, disparaging the emotional brain and blaming our feelings for all of our mistakes. Based upon recent studies of the brain, as Jonah Lehrer puts it in Plato's terms: "the horses and charioteer depend on each other. If it weren't for our emotions, reasons wouldn't exist at all."

Let's look at two specific examples.

First, consumer spending put on "steroids" by credit cards and, second, poor investment decisions based on loss aversion.

It's no surprise that people spend more money when using credit cards than cash. If the same person goes shopping with \$250 from an ATM or a credit card with \$250 availability, studies show that the person with the credit card will buy more. Here's why:

When you buy something with cash, the purchase involves an actual loss- your wallet is literally lighter. Credit cards make the transaction abstract, so you don't feel the downside. Recent brain research shows that using credit cards reduces activity in the insula, a brain region associated with negative feelings. You're anesthetized against the pain with a credit card.

Also, there is a flaw in our brain that overvalues immediate gain (like buying a new pair of shoes) at the cost of future expenses. The emotional brain doesn't understand interest rates or debt payments; that's the work of the rational brain. When a purchaser starts pulling cash from their pockets, insula wakes up the rational brain and negative feelings compete against the positive emotional feelings of the purchase. With credit cards, the rational brain doesn't even get into the debate.

Next time you're going shopping, try an experiment. Go to the ATM, load your pocket with cash, and put your credit cards away for the day. Walk into the

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Deal or No Deal? (continued)

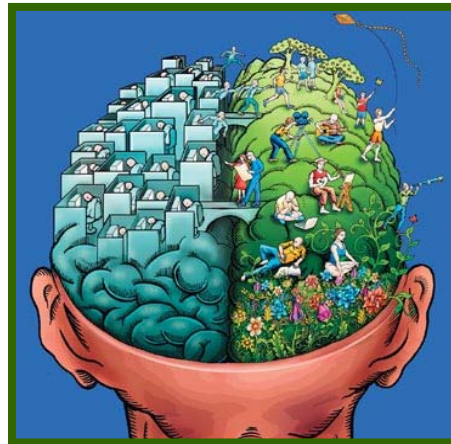
store(s). See and feel how you react to the positive impulses of buying something new and the negative impulses of giving up your cash. I tried it; it's an amazing feeling. You can actually feel the opposing forces at work.

“Loss aversion” is another major “mental defect” that has widespread implications. The desire to avoid loss of any kind often shapes our behavior, leading us to do foolish things. Psychologists Daniel Kahneman and Amos Tversky first demonstrated this concept in the late 70s. Loss aversion often misguides people to make poor investment decisions. People focus on what they have lost or may lose, rather than what they have gained or might gain. In effect, our brains may have a negativity bias built into them. Is it any wonder that golfers at the 19th hole are always talking about the putts they didn't make and that most people are reluctant to make changes?

In the case of houses, for example, Dan Ariely also points out that people assume others will see the transaction from the same perspective as the owner does. We expect the potential buyer to share our feelings and emotions about the positive aspects we feel about our house. Unfortunately, the buyer is more likely to notice the negatives and have very little emotion, particularly in this

market, about our gem. Is it any surprise that there are so many houses sitting on the market right now?

When emotions get involved in investment decisions, problems often occur. Take the example of someone whose retirement portfolio, consisting primarily of stocks, has fallen 50% from its high. Rationally, the investor should be determining the best future action for the remaining portfolio regardless of what the previous value might have been. But, most people can't do that. They will stick with the old allocation, because they don't want to recognize the loss, even if that strategy dooms their long-term financial success. Oblivious to the downside, they are fixated with getting back to “break-even”.



Curiously, if you gave them a stack of cash to invest currently, they could be

entirely rational about the allocation of the new money. But, the emotional attachment to the old holdings and their goal to avert loss at “any” cost, makes it impossible for them to consider an appropriate allocation for the “old money”. One can only imagine how much net worth was lost by investors in the last two years, who held on to stocks, particularly inherited stocks and watched as they went down and down and down.

Interestingly, Damasio and Loewenstein “played an investment game” with neurologically impaired patients who could no longer experience emotion. These individuals did much better on investment decisions than their healthy peers.

Ultimately, we all make lots of decisions everyday. It seems that often times the simpler decisions get dealt with by the emotional brain and the more complex with the rational brain. Jonah Lehrer suggests we've got it backwards. He argues that the easy problems, primarily those solved by math, are the ones best suited for the rational brain and, the more complex problems should have a more emotional thought process, for studies are showing that the supercomputer of the brain is the emotional brain, not the rational one. That's probably why most of the Deal or No Deal contestants walk away defeated.



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