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Six cognitive biases that influence how we save, spend and invest money

We like to think we're rational beings. But the reality is that a lot of our daily behaviour is influenced by our subconscious.

Behavioural scientists have looked at the way human beings are wired and discovered some 'cognitive biases' that influence our everyday behaviour. So if you find yourself clicking on that Amazon special or buying lunch at the same expensive cafe near work every day, they could explain why it's so difficult to stick to your spending limits or saving plan.

Here are a few of their insights into how our minds work.

We tend to discount the future

We value immediate rewards over rewards in the distant future. This tendency to want instant gratification is hard wired from birth. Studies have shown that children find it hard to stop themselves eating a treat even when a bigger and better treat is offered for those who wait for a few minutes. And 'discounting the future' doesn't stop when you reach adulthood. It could explain why it's hard to get too excited about saving for your retirement in your 20s. But the earlier you start planning, the more you'll be able to put away.

We tend to feel the pain of a loss more than the pleasure of a gain

You can see an extreme example of this sort of behaviour at the casino when gamblers chase their losses. This 'loss aversion' can also manifest itself in continuing to commit to a poor investment because you've already put a lot of money into it. It can help to think long term and avoid focusing on short-term fluctuations in the value of your investments.

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We tend to follow the herd

Much as we like to think of ourselves as independent human beings, we tend to look to others for affirmation. Think about the rush to secure seats for the concert when you know that everyone else is using the online booking system. It's all about FOMO. This sort of 'herd mentality' can work in a positive way. Just a generation or two ago it was socially acceptable to smoke in restaurants or to drive without a seatbelt. Now it's unthinkable.

When it comes to money, this 'herd mentality' can manifest itself after stock market downturns, when investors start panicking and selling up, even though rationally this will crystallise their losses. It can help to shut out daily market noise and focus on long-term goals.

We tend to think things are more likely to happen than they are

You can see this in the popularity of lotteries around the world. While the chances of winning are infinitesimal, the winners get a lot of publicity, which makes us think it's more likely to happen. But at least the lottery is relatively harmless. Thanks to the global mass media, this 'availability bias' often focuses on bad events like kidnapping, plane crashes or stock market downturns.

Investors who experience a market crash like the GFC over-estimate the chances of the same thing happening again, even though statistically it's unlikely. It can lead to people saving for retirement changing their investment preferences to lower risk investments, even though this may not be in their best interests as their long-term returns struggle to keep pace with inflation.

We tend to favour recent reference points when making decisions

This 'anchoring bias' can make it easy to overspend in shopping malls. When you first see a pair of shoes for $200 and then a similar pair for $150 it's easy to anchor on the first amount and perceive $150 as a great bargain. And these days it doesn't stop when you leave the mall—online shopping means plenty more opportunities for that anchor to embed itself and end up in an unwanted purchase.

To counter this, try setting your own 'base price' before you set out shopping and stick to it. You can also see anchoring in practice when investors rush in to buy stocks that have just plunged in value without looking at the underlying performance of the company. They have made the mistake of anchoring the recent high point in their mind.

We tend to be a bit lazy

We tend to stick with current plans rather than change if it's too much hassle. This is probably why so many of us stay with our utility providers rather than shopping around for a better deal. If you find yourself suffering from 'status quo bias', try making a start with one area of the household finances—say, your electricity bill—to make it more manageable, rather than trying to tackle everything at once.

Source: AMP