3 ways emotions can sabotage your finances

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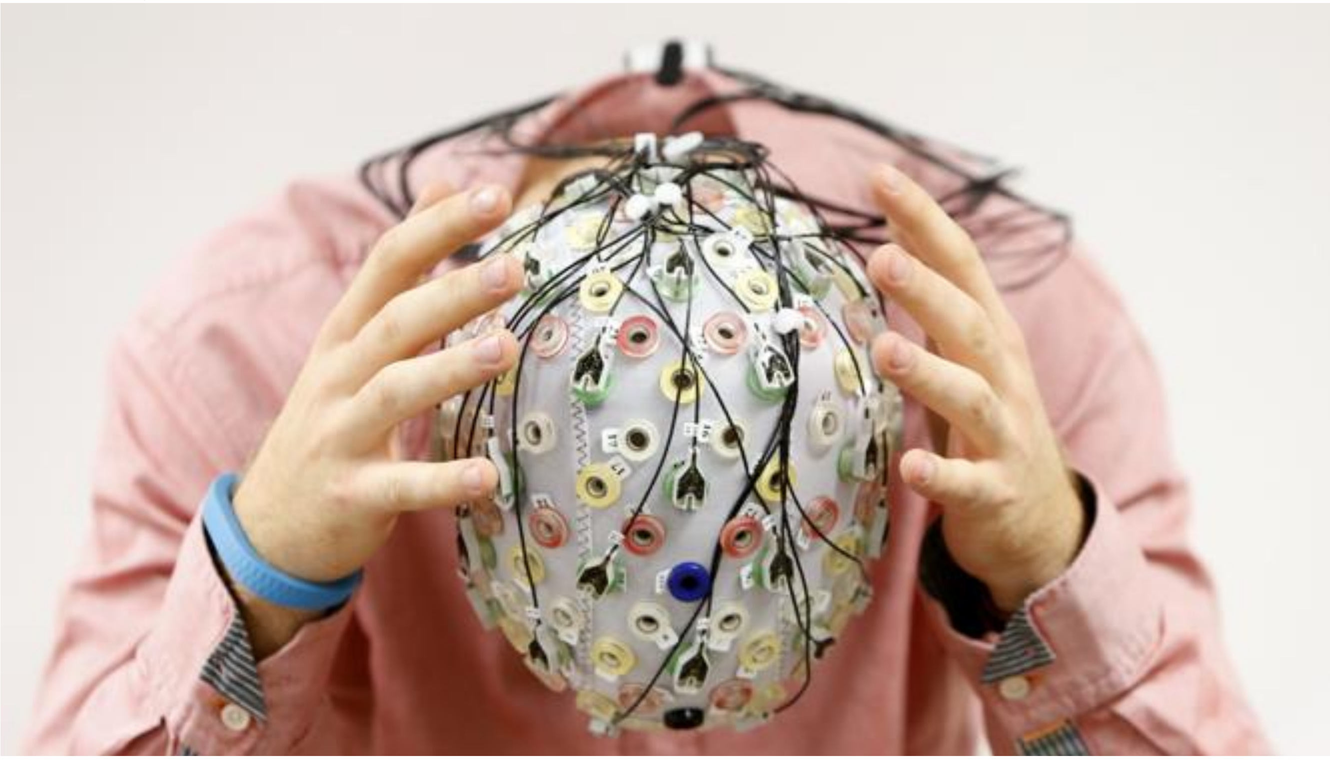

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What if the answer to solving most of your money problems was all in your head?

According to the field of behavioral economics, humans are practically hard-wired to overspend and let their emotions steer their financial decisions (often in the wrong direction). The pull of our emotions can be so strong that even when facts are presented clearly to us — we must save for retirement, we must not spend more than we earn — again and again, we find ourselves falling short.

In "THINKING MONEY: The Psychology Behind our Best and Worst Financial Decisions," a new documentary that aired on public television this week, a team of behavioral economists and financial experts help pick apart the human brain in an effort to reveal exactly how it can so often work against us — and what we can do to stop it.

"The ability of the emotional mind to overcome the rational side of our brain is the scary thing," says Gerri Walsh, president of the FINRA Investor Education Foundation, which sponsored the film. "We wanted to translate these concepts into plain English and also give individuals something they could do to help them overcome them."

Here are a few ways your mind is playing tricks on you:

We are too easily intoxicated by price.

In a compelling study by Caltech, everyday consumers were asked to sample a selection of wines. The samples were actually all of the same wine, but the researchers gave each participant a different price point for each sample.

While they drank the wine, an MRI machine tracked their brains' pleasure sensors. The researchers found that when people believed they were drinking pricier wines, they were happier and seemed to enjoy it more. In other words, our brain mistakes high price for high quality.

Now, apply this irrational thought process to some real world situations and you can see how dangerous it can be for our finances.

For example, some people favor brand-name drugs over generics, even though the ingredients are the same. That kind of irrational decision might cost you a few extra bucks. But mistaking price for quality can cause real harm to investors, especially as they shop around for financial advisors, brokers or new investments. Some investors may favor mutual funds that have high fees just because they have a higher Morningstar rating, despite the fact that those fees can hurt their portfolio. And in the context of fraud, Walsh says scammers often use people's irrational preference for price and exclusivity to swindle them. Those high pressure tactics can convince people to make bad investment choices simply because they feel as if they'll miss out otherwise.

The solution for most people is to always choose investments with a healthy dose of skepticism.

"If people devoted as much time and energy to comparison shopping for investments and financial advice as they do using Yelp to figure out where they're going to go for dinner, you might see better outcomes," Walsh says. "We all want that easy path, but a lot of those decisions are complex. They take time and require research."

Our caveman instincts tell us to trust our gut first, brains later.

Behind some of our predisposal to spend rather than save are our ancestors — primitive beings who often relied on gut instincts to steer them clear of danger. Over time, our rational brain (the side of the brain that allows us to solve problems), began to grow and compete with the irrational, emotional side. But gut instincts still dominate our actions, at least when it comes to the choice between saving or spending.

"The rational brain simply rationalizes whatever the emotional brain has already decided to do," explains Dr. Baba Shiv, a neuroeconomist at Stanford University 's Graduate School of Business, who's featured in the documentary.

We walk into a store, fall in love with a $200 blazer and then use our rational brain to convince ourselves that we deserve it or that we should buy it because it's a good investment for our wardrobe. When a relative asks us to invest in his new company, we trust our emotional connection and cut them a check before vetting their business plan.

The solution? Fight fire with fire, Shiv says. To make better choices about saving, we need to find ways to make saving more emotionally appealing.

You can do that in a number of ways today. Goal-setting website Stickk uses a controversial — yet effective — premise to get users to stick to their goals, which can be anything from losing weight to saving up for a vacation. If you fall short of your goal, you commit to letting Stickk charge you a certain amount of cash. That cash can either go to Stickk, a friend of yours, or (most effectively) get sent to a charitable cause that you hate. Stickk calls it the "anti-charity." The emotional fear of losing money may be enough to encourage you to stay on top of your goals, they reason.

There are other, less-extreme ways to go about it as well. SaveUp lets you link your financial accounts to their site. Each time you do something financially savvy — like paying off a credit card, contributing to a 401(k) or a savings account — the site rewards you with SaveUp points which you can redeem for prizes. Similarly, SmartyPig lets you set savings goals and each time you reach one, you're rewarded with cash or a gift card based on a percentage of whatever you've saved.

When we have too many options, we choke.

If you've ever caught yourself in a daze, unable to choose from the seemingly infinite kinds of cereal in the supermarket, or pick a fund from the 15 options provided by your employer's 401(k) plan, chances are you've fallen into the choice trap.

"When you have too much choice, which is often accompanied by too much information, people suffer," says Sheena Iyengar, a Columbia Business School professor and author of "The Art of Choosing". "They procrastinate, so they're less likely to make a choice. They make more errors in what they choose."

This inability to select a choice from a wealth of options may be the reason why Americans are unlikely to save for retirement if their employer does not automatically enroll them in a plan. In a recent study by Vanguard, researchers found that employees who were auto-enrolled in a 401(k) plan by their employer and given the option to withdraw had an overall participation rate of 82%, compared with a 65% participation rate for employees who had to join voluntarily.

Researchers like Iyengar encourage people to find ways to simplify the decision-making process. If you're stumped by 401(k) plan options, rather than tackling a number of choices all at once, set a goal to review your options in small chunk of three or five at a time. And if you're wary of setting up a long-term retirement plan, asking a financial advisor for help can take a lot of the burden off your shoulders. Have an expert crunch the numbers and tell you exactly how much you need to save today in order to be able to afford "tomorrow."

"Saving for retirement involves math, which for a lot of people is even scarier than thinking about retirement," Walsh says. "But you can't ever know the target you should be shooting for unless you take the time to do that analysis."