The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

How the *framing* phenomenon affects your key financial decisions

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Think about these behavioral oddities:

People are more likely to choose meat that's labelled 85% lean over meat labelled 15% fat.

Twice as many people opt for surgery that claims to have a 90% chance of success, versus surgery claiming to have a 10% chance of failure.

Take a full, four-ounce glass and pour out two ounces. Sixty-nine percent of people will say the glass is half empty. Pour two ounces into an empty four-ounce glass; 88% will say it is half full.

Each of the above examples takes identical results and changes the context, or *frames* the results, in a way that affects your responses. In this article, I'd like to discuss how the phenomenon of framing affects your key financial decisions.

Political pollsters know how easy it is to affect results: They simply change the way they frame their questions! For instance, in one poll they asked, "Politically, do you consider yourself: a) conservative, b) liberal, c) neither?" The results were 58%, 30% and 12%, respectively. But when option c) was changed from "neither" to "middle of the road," the tally changed dramatically, to 38%, 20% and 42%.

Traditional economics assumes people make rational choices – and will make the same choices, no matter how these choices are presented, or framed. But research in behavioral finance shows that, in fact, financial decisions can be wildly influenced by framing.

It's all in the framing

Consider the following:

You have entered and won two contests. Contest #1 gives you a prize of $100. But before you leave with the money, you get an option to receive another $50 outright (option A), or flip a coin (option B). If the coin is heads, you win another $100. If it is tails, you win nothing, but keep your original $100. If you're like most people, you choose A, locking in the $50 gain. Your *bird-in-the-hand* bias has been triggered.

Contest #2 gives you a $200 prize. But you must either give back $50 and leave with $150 (option C), or flip a coin (option D). If the coin lands heads, you must give back $100 and leave with $100. If the coin lands tails, you lose nothing and get to keep the entire $200 prize. Again, if you're like most people, you choose D, gambling on a gain to avoid locking in a $50 loss. Your *aversion-to-loss* bias has been triggered.

Now that is odd, because option A in Contest #1 and option C in Contest #2 have identical results! You leave with $150, guaranteed. And options B and D also have identical results – you have a 50:50 chance of leaving with either $100 or $200.

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Why do people's choices differ in each example? It's simply because of the way those choices were framed.

Let's say you invested $20,000 in a stock that has now fallen to $10,000. Your instinctive *loss aversion* means you will likely avoid selling because that would lock in a big loss – even if you know that, by not selling, the value could fall even further. It may also be that you've become *anchored* to the original price. You may believe it is worth $20,000, and that makes you willing to gamble the stock will rise again.

Now, reframe your situation. Imagine you have never owned the stock, and you have $10,000 in cash available. Would you buy that stock today? If you answer "No," that means you don't think the stock is worth $10,000. So, you should probably sell to cut your losses.

Being aware of how we are affected by framing can help us avoid behavioral biases that lead to mistakes. Used properly, framing can also help us make the right decisions. When confronted with financial choices, try to think of different ways of framing your options, to see if you come to different decisions. ■

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