THE IMPACT OF COGNITIVE BIASES ON INVESTMENT DECISION-MAKING USING THALER‘S SMART PROGRAMME

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1 INTRODUCTION

When making financial decisions, people are often subject to various cognitive biases that influence their judgements and choices. This paper examines seven major cognitive biases that are commonly found in financial decision making: present focus, self-regulation problems, cognitive overload and procrastination, status quo bias, uncertainty tolerance, perceived lack of self-control, and „mental accounting“. These biases have a significant impact on financial decisions and understanding them can help individuals make more informed and rational decisions. Financial advice can play a key role in reducing these biases, as financial professionals can help people make more objective and informed decisions. In Thaler‘s SMarT programme, a form of counselling is used to help individuals make more rational decisions [1].

Saving is important because it provides financial security, helps you prepare for unexpected expenses, major investments (e.g. buying a home or retirement) and gives you the opportunity to achieve your long-term goals [2]. Cognitive biases play a significant role in why people do not save regularly. Short-term thinking makes it difficult to grow long-term savings, which applies to both monthly fee-based savings and lump-sum longer-term investments, where investment providers recommend holding beyond one year. People tend to favour the present moment over the future, it makes it difficult to find motivation to put money aside for the future [3]. These behavioural biases make it difficult to develop savings habits, so increasing financial awareness, automated savings systems (e.g., automatic monthly savings) and conscious planning can help overcome these barriers [4].

2 MATERIAL AND METHOD

Secondary data and conceptualisation were obtained through a literature review of the topic, focusing on Thaler‘s SMarT programme. As a starting point for an incipient research, we consider the first research results of the SMarT programme, taking into account the psychological lessons and conclusions it contains. The “Save More Tomorrow” (SMT) program is a savings strategy based on behavioural economics [5]. The importance of the program lies in the fact that it helps people to automatically increase their savings in the future, especially for retirement savings, without having to make immediate sacrifices by giving up part of their future salary increase for the benefit of their retirement savings.

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3 RESULTS

The SMarT plan was first used in 1998 in a medium-sized manufacturing company. Of 286 employees who spoke to a financial adviser, only 79 (28%) were willing to take his advice. To the remaining participants, the consultant deliberately offered a version of the SMarT plan. Of the 207 participants who took part in the programme, 8% agreed to join the SMarT plan. Virtually everyone (98%) who joined the plan stayed in it through two salary increases, and the vast majority (80%) stayed in it through the third salary increase. Furthermore, even those who left the plan did not reduce their contribution rates to the original level, they simply prevented future increases. The average savings rate of SMarT plan participants increased from 3.5% to 11.6% in 28 months [6].

In summary, the SMT scheme is significant because it helps people overcome their natural financial procrastination tendencies and automatically increases their savings rate, especially for retirement purposes, without having to make dramatic changes to their current lifestyle. The principles of the programme are:

1. Automatic participation and commitment to the future;
2. Applying behavioural economics;
3. Gradual increase in savings: a key feature of the scheme is that savings are increased gradually as people‘s salaries rise;
4. Increase of long-term financial security.

Of course, there have been those who have questioned its relevance, particularly in terms of the extent to which foregoing future resources because of the scheme will induce people to find other sources to supplement their own budget when necessary [7].

The main cognitive biases that play a role in the SMT programme are:

1. Status quo bias: people tend to stick to the status quo;
2. Loss aversion: people feel more pain from losses than joy from gains;
3. Present bias: people value present benefits more highly than future ones;
4. Hyperbolic discounting: this bias suggests that people tend to value short-term benefits more than long-term ones;
5. Procrastination: The SMT programme helps overcome this by timing savings growth for the future;
6. Inertia: people tend not to change their existing financial habits, even if it would be beneficial.

Overall, the SMT programme exploits a number of cognitive biases to overcome people‘s natural financial procrastination tendencies and help them to increase their savings in the long term, especially in preparation for retirement.

4 CONCLUSIONS

In conclusion, our decisions are influenced by a number of cognitive biases, and in order to make decisions with the most rational content for the situation and circumstances, it is essential to detect the most important biases. For people, especially when it comes to financial decisions about saving and investing, it is important to be able to offer support and advice, which we can provide in the form of financial professionals and advisers. The SmarT programme has proven that with the right communication, we can influence individuals to make decisions not only in the present but also in the future, supporting their own future.

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