Behavioral finance

The restraint bias: How much self control do you really have?

By Stan Clark - Senior Investment Advisor

One old Seinfeld episode shows clearly the main features of what behavioural finance experts call “restraint bias.”

In the episode, Jerry follows George’s hot stock tip and buys some shares. George tells Jerry to be patient. The ever-confident Jerry is sure he can. But the stock is slow to develop. Jerry starts obsessively reading the daily stock market reports, wincing every time he sees the stock drop another point or two (if it had been today, he would have been checking online every few minutes!). Finally, in a panic, he sells, losing more than half his money. A day or two later, George reports that the stock is soaring. So Jerry should have restrained his urge to sell.

Now, that’s not a perfect example of restraint bias, but it comes close. As you may recall from reading previous editions of Perspectives, there are a number of ingrained psychological biases. They all lead to patterns of poor judgment. They can profoundly affect the way we behave in the stock market and in other areas of our lives.

Confirmation bias leads us to search for or interpret data to confirm our preconceptions. Anchoring causes us to rely too heavily on single pieces of information when making choices. The money illusion causes us to put more emphasis on the face value of money than on its purchasing power.

As I’ve just shown by the Seinfeld example, there’s also restraint bias, leading us to over-estimate our ability to withstand temptation. This is one of the key behaviours that makes it so hard for people to quit smoking, to stop over-drinking (or any other addiction), to lose weight – in short, to avoid any number of harmful behaviours.

People trying to lose weight believe they can restrain themselves, so they continue buying their favourite snack foods, like ice cream, thinking “I’ll just have one spoonful every now and then.” Smokers may keep a few cigarettes on hand (just in case something really stressful happens) or continue to engage in behaviours closely associated with smoking, like going out for drinks with friends. Someone who needs to get out and exercise turns the TV on to the hockey game for a few minutes “just to check the score” – and ends up sitting in front of the TV for the rest of the day.

In one study, students arriving at, or leaving, a cafeteria were asked to rate a number of snacks from least desirable to most. They were then asked to select one of the snacks but not to eat it. Then they were told if they brought the snack back in two weeks they would received a desirable reward.

Hungry students entering the cafeteria tended to pick a less desirable snack, to avoid the temptation to eat it right away. But students leaving the cafeteria after a meal felt they could easily resist any snack because they were no longer hungry. So, they tended to confidently choose one of their favourite snacks. Guess which group resisted temptation best and exchanged their snacks for the promised rewards? That’s right – the ones facing the least temptation.

At a personal financial level, simply carrying your credit card increases the likelihood that you will be tempted to buy something instead of saving your money. Listening to hot tips can tempt you to make bad choices about buying or selling, and following the news too closely can tempt you to abandon a carefully thought-out, objective investment strategy in hopes of making a quick gain, or avoiding a loss.

Just remember, it’s a rare person who can resist temptation. Studies show the very people who believe they have the most will power or self-control are the ones most likely to behave impulsively. With all the holiday goodies around this time of year, it’s a good time to observe the effects of the restraint bias. Remember these same types of temptations also affect the financial and investment decisions you make year round.

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