Getting Taxed

#7 – Andy Reed, VP of Behavioral Economics at Fidelity Investments

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Description: Andy Reed, VP of Behavioral Economics at Fidelity, joins us to provide insight into some of the ways investors make decisions surrounding their emotions and frames of knowledge, and how these factors can impact tax-efficient decision making for the investor.

Transcript

Erol Senel:

Welcome to Getting Taxed, where we discuss important tax related topics so you can make more informed and impactful decisions. But first, remember that Fidelity doesn't give tax advice and nothing we discuss today should be interpreted as tax advice.

Erol Senel:

The information provided is going to be general in nature and may not apply to your specific situation. If you have tax questions about your specific situation, you should speak with a tax advisor. With that said, let's talk behavioral finance.

Erol Senel:

(Singing)

Erol Senel:

Hey everybody, I'm Erol Senel, a Director here at Fidelity Investments and today I'm joined by Andy Reed, VP of Behavioral Economics at Fidelity. Andy, welcome.

Andy Reed:

Thanks Erol. Very glad to be here.

Erol Senel:

So you have a really interesting background, which we're going to get into in a minute and obviously throughout the course of this conversation, but you've also been with Fidelity for a few years. I'm curious, how has your background in behavioral economics influenced the work that you're doing here? Yeah,

Andy Reed:

I would say over the past few years, my work at Fidelity has really gone back to my roots in academic research. So what my team and I try to do is understand really some of the fundamental ways in which investors make decisions for better or worse. And this ranges from how much choice they want to how they weigh gains versus losses to how much risk they can tolerate. So I lead a small, but mighty team of behavioral researchers who are studying how to help our clients make better choices, despite all of the challenges that come with ultimately being human.

Erol Senel:

I mean, obviously, as you're saying, there's a ton of different things that are coming at you as a human. So it's going to be really interesting to get into all this. I just kind of want to start with the level set.

Erol Senel:

Why is it important to think about just behavior in general when it comes to economic topics and how you make decisions there?

Andy Reed:

Yeah. My favorite answer to this is the old saying that all economics is behavioral economics and economists will tell us that there's an optimal sort of "rational" way to make decisions that usually involves a lot of complex math. But the reality is that humans aren't wired to make decisions this way.

Andy Reed:

We have to design products, experiences messaging around sort of the quirks and foibles let's call it of human nature rather than designing for this mythical, rational human being.

Erol Senel:

So you mean we're not all computers?

Andy Reed:

Far from it, yeah.

Erol Senel:

When did you really begin to realize that this was an area of interest for you?

Andy Reed:

Yeah, I was really lucky. So for me the light bulb moment was as an undergrad, I was studying with Barry Schwartz who wrote The Paradox of Choice. And this was one of the first books that brought behavioral economics to the public sphere. And his teaching really opened my eyes to the reality that people think they're rational, right. We're really motivated to think that we're really smart. We're really knowledgeable. We're really good at what we do, but our preferences, our decisions, our behaviors suggest otherwise.

Erol Senel:

I cannot argue with that, that really hit home in some kind of weird way. I mean that's like an internal misconception that we have about ourselves. But when you think about some of the misconceptions that we just have in general around human behavior and how that actually influences our decision making, what are some of those misconceptions that we should be aware of?

Andy Reed:

Yeah, there's the few of them. So one is that more choice is better. And you know there's this common notion that if some choice is good, then more must be even better, right? You can't have too much of a good thing. And the reality is when the amount of choice, the amount of information that's in front of us, sort of exceeds our ability to process that information. So again, as you said, we're not computers, it's really hard to make any choice. And even if we do make a choice, we may be dissatisfied. We may have second guessed ourselves and we may even regret the choice.

Andy Reed:

One of the challenges is figuring out what's the right amount of choice for people because unlimited choice sets aren't necessarily a good thing. I would say the second misconception is that the way we think about gains and losses is equal and opposite, right?

Andy Reed:

So that's what economists would tell you, gaining a dollar should feel as good as losing a dollar feels bad. But what behavioral economists would tell you is that losing a dollar feels twice as bad as gaining a dollar feels good. So we feel the pain of losses more acutely than the pleasure of gains. And this has some important implications about how people react to and think about gains and losses in their portfolio.

Andy Reed:

The third and fourth misconceptions are about knowledge. And so there's this notion that people have clear preferences, they know what they want, and they also have clear knowledge. They know what they know. The reality is in many cases we make up our preferences as we go along, right? You don't come into a decision context and say, "I want ABC and I'm just going to look through all the options until I find the one that's exactly what I want."

Andy Reed:

The reality is the options themselves and the way they're presented actually shape your preferences in the moment. On the knowledge side of things, a lot of people let's say are mis-calibrated in terms of their knowledge. So they may think that they know less than they actually know. They may think that they know more than they actually know.

Andy Reed:

When you compare people's objective knowledge, when you measure their knowledge about things like investing, things like risk against their subjective knowledge, which is how knowledgeable and confident they think they are. There's often a pretty big gap. I would say a lot of people are over confident, but at the same time, a lot of people are under confident.

Andy Reed:

The last misconception, and this is a big one. This might even be the biggest one in all of behavioral economics is that emotions are bad for decision making and you have to suppress emotions in order to make good decisions. And it's true that some emotions like stress and anxiety can undermine our ability to think clearly about options and make trade offs between the present and future.

Andy Reed:

Positive emotions like gratitude and pride can actually make us more patient. They can help us think more flexibly and even provide short-term boosts to our memory. I would say before you make any complex choices about investments being in the right mood can be absolutely helpful. It doesn't necessarily hurt your decisions at all.

Erol Senel:

It's been interesting. I found myself doing that more and more. It's like, okay, you just got to figure out where are you before you take any action? Am I in the right mindset? It plays a huge role. I just want to build on, on that for a moment, because there were a few things there that you hit on that I think really kind of resonated with some of just like my own experiences, but what is it about humans that allows them to make poor decisions, even when they're aware that there's potentially better decisions to be made?

Andy Reed:

Yeah, it's a great question. And I would say there's a few possible answers. So on the one hand, it may be a matter of motivation. So we're not always looking to "maximize" and seek the best possible alternative. A lot of times we just engage in what's referred to as satisfying. So we look for something that's good enough. We put just enough effort to find something that's just satisfactory enough. And the question is, are you willing to put forth more time and energy to eke out in the context of investing a few more basis points and maybe, maybe not, it depends.

Andy Reed:

Other times it could be a matter of skill and knowledge. So we may think that we've made the right choice due to a misunderstanding or overconfidence. So our research shows, for example, that three quarters of millennials are confident in their financial decision-making skills, but only 17% understand basic financial concepts like compound growth or inflation. And so there's a big gap as I mentioned earlier before between what we know and what we think we know.

Andy Reed:

I would say that the third explanation and this one tends to be underappreciated is that all too often, it's actually not our fault as human beings. It's more the environment that's not designed with humans in mind. So for example, even experts who really know what they're doing can struggle to make good choices when they face an overwhelming amount of choice, complex jargon or confusing decision menus. I would say never underestimate the power of the environment to influence the choices that we make.

Erol Senel:

And power of the environment and also maybe whether it's just presented in a complex way or maybe an overly simplified way too, can have a big impact on what kind of decision we end up making, which is interesting. So I want to build off of that for just a moment. We all know that taxes are an inevitability, whenever we're dealing with money and investors, many investors are very fee sensitive. They don't want to pay extra than they necessarily have to.

Erol Senel:

So I'm curious why aren't more investors engaged in making better, tax-efficient investing decisions, even when they know the financial benefit of it. Is there some kind of emotional firewall that's up there that's preventing that from happening?

Andy Reed:

Yeah, I would say there's definitely a few different behavioral biases that make it hard to think clear early about taxes investing. So first off we're not great as human beings at planning for the future. There's lots of research on what's referred to as the present bias, showing that we place more value on the here and now than on the future. So you may have heard of this famous marshmallow test where you give young children a choice between you could either have one marshmallow now, or if you wait 10 minutes, you get two marshmallows.

Erol Senel:

Yeah.

Andy Reed:

And we know that two is better than one, but we're hardwired to maximize the present. And so waiting for the delayed payoff requires a lot of self-control and that's not everybody's strong suit.

Andy Reed:

The second piece is that I kind of mentioned this earlier before, but our emotions aren't really well calibrated to gains and losses. There's about many decades of research on loss aversion, going back to Daniel Kahneman and Amos Tversky really Nobel winning research showing that we feel the pain of losses about twice as strongly as the pleasure of gains. And one consequence of this in investing is the so-called disposition effect.

Andy Reed:

So this is where investors hold onto losing stocks longer than winning ones in the hopes of avoiding the loss. And this is precisely the opposite of a tax efficient strategy. I would say third, the average investor may have a blind spot when it comes to tax efficient strategies. So believe it or not two thirds of Americans aren't aware of basic financial principles. So when it comes to buying and selling stocks, they may not habitually consider the implications for taxes. Now, that being said, they're certainly motivated to reduce their taxes.

Andy Reed:

So when you make those implications clear and salient, it absolutely influences their behavior. One other thing that we should be aware of is that people really tend to systematically underestimate the power of compounding. And in fact there's a name for this. It's the exponential growth bias. If you think about the benefit of tax lost harvesting for example, it compounds over time. So it may only be one or two percentage points each year, but over time that can grow substantially. And so you have to think about it kind of like a habit, right? It's almost like flossing your teeth. You have to do it every day to reap the benefits. If you don't do it, then the costs of not flossing grow over time, right? The pain, the suffering, the dental bills increase as you sort of avoid that beneficial habit.

Andy Reed:

Now the challenge when it comes to tax loss harvesting is the average person can't necessarily do all the math, right? You can't sit down, do all the calculations, figure out the implications of every single decision. But you know, the fortunate thing is we have technological aids, right? We've got calculators, we've got tools, we've got professionals that can help us.

Andy Reed:

So unlike flossing you do have a little bit of backup if you need it, but again those benefits do accrue over time. It's just hard as human beings to do the math and calculate what the lifetime benefit of engaging in these types of behaviors might be.

Erol Senel:

I just kind of want to unpack that a little bit or maybe give a little bit of a tidbit that people can walk away from just hearing that last part, especially with the immediate benefit to delayed gratification part of it. Where can regular investors start in terms of being more aware so that they can take that step and potentially making better decisions when it comes to emotions and making more sound and objective judgements?

Andy Reed:

Yeah, I would say you hit the nail on the head. Awareness is a good first step. So I think there's evidence that just learning about it and recognizing that you may be susceptible to these innate tendencies can actually help you overcome them. Along the same lines there seems to be a lot of evidence that making more mindful decisions is the key.

Andy Reed:

We may not be hardwired to be sort of rational so to speak, but that doesn't mean that we can't overcome the sort of innate tendencies and biases that are sort of the easy route. And so that might mean pausing to reflect on your gut feelings about options, getting a second opinion from an expert or sleeping on it. Any way that you can sort of take a step back and get out of that sort of tunnel vision mode that can often dominate our decision making is a good idea.

Erol Senel:

Yeah, Sorry. I mean, I definitely the tunnel vision, but also the impulse mode. For some reason there's just something and it happens to everyone I think that when they're about to make a decision, it's like, okay, if I don't do it now, I'm not going to act. So I just got to do it.

Erol Senel:

So it's I think just a matter of like you said, being mindful, what's causing that feeling and should I pause, should I take time to consult my advisor first so that I can actually see if this is the right decision based off of a lot of different variables versus just the one that's kind of staring me in the face at this moment.

Erol Senel:

Clearly, I mean investing and planning for tax impact is easier said than done. It's a tough thing to grasp at times, but it's definitely something that we should pay attention to because we know from a foundational principle that it does have a big impact over time. I think one of those things, like you said is just to try to be a little bit more mindful. Slow down a little bit, and to really try to understand are your emotions or are some of your thoughts kind of pulling you away from making a better decision in that space?

Erol Senel:

So, Andy, I want to just thank you for this. I always love talking about this stuff, so thank you very much.

Andy Reed:

Thank you.

Erol Senel:

And that's all we have for today's episode and be sure to think about how the topic discussed today can help you from getting taxed too much. Goodbye for now.