Why Behavioral Finance Matters

[Monday's post on the pass-thru income deduction contained one small error. However, it was an important one. The post has been updated and if you are an independent contractor and thought the pass-thru deduction wouldn't apply to you because you don't have employees or aren't an S Corp, I suggest you go back and read the updated version. My apologies.

This post is a guest post from Ryan Inman, a fee-only financial planner who specializes in helping physicians through his firm, Physician Wealth Services and his podcast Financial Residency. He is a paying advertiser at WCI. In this post, he explains why doctors need to know about behavioral finance.]

The Physician Approach: Confident, Methodical, Expert. *Rational*.

As physicians, you are trained to make the best, most accurate choices possible for your patients. When you hear a list of symptoms, your years of training instantaneously kick in like clockwork. The Rolodex of possible ailments turns in your mind until you land on what you believe to be the correct one. You know the tests to order, the exact prescription to write or the precise place to cut.

Even in the moments you're not sure, you're trained to project confidence. You're the physician. You're the expert. You're the one with the answers. You've survived medical school and residency. You're resilient, and you've worked for years to get the knowledge that sits in your mind at this very moment.

As such, it's second nature to apply this same methodical approach to decision making to other aspects of your life.

Take money, for example. As a well-educated person, you know you need to save money for the future. Perhaps, as a reader of this blog, you've learned about Nobel prize-winning research that recommends investing in index funds rather than trying to beat the market.

A Different Approach

But what if another Nobel Prize winner could help you uncover a system for truly mastering your finances? What if a different type of research that examines your emotions and reactions could be a better predictor of your future financial success?

Enter Behavioral Finance. Why We Do the Opposite of What's Rational

In December 2017, Richard Thaler – an expert in behavioral finance – won a Nobel Prize for his life's work.

As Bloomberg reported, "Thaler has devoted his career to developing an idea that challenges orthodox economics – the fact that humans aren't always rational, and don't always act in their own best interests. Among other things, they lack self-control, they're inconsistent in how they value things, they have an outsized fear of losses, and they overreact to bad news."

In sum, sometimes we know what's best for us when it comes to our finances, but we do the opposite. Sometimes, our emotions outweigh what's rational. Sometimes, we want what's immediately in front of us even though we know it's better if we wait.

Are Doctors Financially Irrational?

The reason doctors should care about behavioral finance theory is that the physician population is **more susceptible** to having irrational emotions with respect to money.

One classic example is of the overworked resident who finally gets his or her attending salary. You powered through the brutal residency period of your life whether it was 3 years or 7 years, and you got out in one piece.

All of a sudden, you get that first job, and as a result, *that first glorious paycheck.* *Cue the angels singing.*

This is When Behavioral Finance – Not Rational, Mathematical Finance – Matters!

Doctors in this position are much more likely to go out and finally get a nice car before they start aggressively paying back their student loans. They might buy a beautiful home, book a nice vacation for the holidays, or actually order some new clothes for work without digging through the sale racks.

And, I'm not saying that this is inherently wrong. After all, my wife did a three-year residency and then a three-year fellowship, so I understand the sacrifices physicians make and the need to feel a return on that investment.

What *is* wrong with this or what *could* happen in this situation is that physicians will be prone to focus **too much** on short-term pleasure at the expense of long-term wealth.

My recommendation as someone who works only with physician clients daily is to do a thorough assessment of your life goals. What I do really isn't just financial planning – it's one-on-one life planning.

5 Behavioral Recommendations for Achieving Long-Term Wealth

1. Answer the "3 Questions"

Popularized by the "father of life planning," George Kinder, the 3 questions help people get to the core of **what matters most.**

> ***Question One:*** *I want you to imagine that you are financially secure, that you have enough money to take care of your needs, now and in the future. The question is, how would you*

> *live your life? What would you do with the money? Would you change anything? Let yourself go. Don’t hold back your dreams. Describe a life that is complete, that is richly yours.*
>
> ***Question Two:*** *This time, you visit your doctor who tells you that you have five to ten years left to live. The good part is that you won’t ever feel sick. The bad news is that you will have no notice of the moment of your death. What will you do in the time you have remaining to live? Will you change your life, and how will you do it?*
>
> ***Question Three:*** *This time, your doctor shocks you with the news that you have only one day left to live. Notice what feelings arise as you confront your very real mortality. Ask yourself: What dreams will be left unfulfilled? What do I wish I had finished or had been? What do I wish I had done? What did I miss?*

While they are simple questions, the answers that come from them are **powerful and impactful**.

These are questions you should answer on your own. Don’t consult with your spouse if you have one. Be in a quiet, comfortable place with no distractions. Spend the next hour really thinking, reading and answering these 3 questions.

While you are answering, think about what would allow you to live a truly fulfilled life. What does your great life look like? Don’t let obstacles or reasons why you can’t do something that is truly important to you interrupt your thoughts. Write freely. Give yourself the freedom to identify your dreams and bring them to life.

2. Write Down Your Top Goals

After you finish answering the 3 questions, narrow down your answers to identify your top goals. Break it down into time periods. What do you want to accomplish in 3 months, 6 months, 1 year, 5 years from now, or in your lifetime?

For you, that might be traveling the world or buying a second house on the lake.

For others, that might be saving 50% of their income so they can pay for their children's medical school education in cash someday. Some doctors are interested in entrepreneurship, investing in real estate, or retiring early. Maybe you just want to like Mondays again.

As such, a [financial plan for doctors isn't one size fits all](). However, I've learned after working with doctors and being married to one that it's very hard for them to resist immediate gratification, **especially when a great income is there and available to spend.**

So, when you write down your goals, keep them in a prominent location that you can see and refer to daily. If you do this and have your core goals in mind, you're much less likely to be tempted by the negative behavioral finance tendencies that plague us all.

3. [Make it Automatic]()

According to [researchers at Harvard University](), auto-enrolling employees into retirement savings plans increases retirement savings. That might seem like a no-brainer, but how many times have you put off doing something because it required time and paperwork?

Auto-enrolling employees takes the human aspect out of retirement savings. It prevents us from doing that human thing called procrastinating. **It saves us from ourselves.** And, you can apply this same theory to short-term savings goals too.

For example, you can automatically put money in your kids' college accounts, automatically invest, and even automatically pay off your credit cards in full at the end of each month.

You're busy every single day, so do yourself a favor and set up several automatic transfers every time you get a paycheck. Then, work with the money that's left throughout the rest of the month.

This will help you reduce the temptation to spend your full paycheck and will help you save for both short-term and long-term goals in the process.

4. Treat Yourself

This advice might seem counterintuitive to the point of the article, but hear me out. You don't work as hard as you do to live a life that's lacking. Plus, the more you try to avoid certain indulgences, be it nice dinners out or a monthly massage, the more you'll want them. Again, that's human behavior.

So, I'm not suggesting a life void of extras. What I am advising against is focusing too much on these short-term pleasures, because it can put your long-term wealth at risk.

Make sure that your spending is aligned with your vision of your ideal life, that you prioritize the things that are really important to you and block out everything else.

Remember, you can only spend a dollar once, so make sure that when you assign the dollar its job (whether that's an expense or an investment) that you are making the best decision based on your goals.

5. Finding the Balance

Ryan Inman

Luckily, by being attuned to recent research in behavioral finance, you will have a heightened awareness of your own money habits. You'll be able to step back and identify when you're being a little *too* indulgent, which can help you make wiser long-term financial decisions.

Also, by identifying your goals and actually writing down a long-term plan, you can keep what's most important at the forefront of your mind. This, in turn, will help you resist some of the short-term purchases that will only give you momentary happiness in favor of long-term financial independence.

Ultimately, the path to financial freedom as a physician is more complicated than it seems at first. It's so much more than doing your research and running the numbers. Long-term wealth accumulation requires honing your skills and noticing where you are financially weak. And, even though behavioral finance highlights where we, as humans, are lacking, being more aware of our tendencies can actually encourage us to have more discipline and motivation when it comes to our money.

What do you think? Do you think doctors are more financially irrational than other professions? How have you stuck to your financial plan even when your emotions are screaming to bail on it?