



What's Your Instinct? Head vs. Heart

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Is it better to be an emotional or rational thinker? The answer may surprise you.

It's easy to see why the heart—our emotional, intuitive side—is almost always cast as the villain when it comes to decision-making. Despite our best efforts to be logical and stay cool, our hearts can lead us astray. In the classic cliché: The stock market plummets. What's your heart's response? To sell, of course, though hindsight will more than likely confirm that buying would have made more sense.

But is the heart simply a stumbling block, bent on corrupting the good decisions made by our more logical, rational self? While our emotions, when left unchecked, can contribute to poor choices, our heart is absolutely necessary to making our most intelligent decisions. To see why, let's first take a look back at human history.

Hard-Wired by Evolution

Neuroscientists believe our brains are hard-wired by evolution, with our more emotional side being much older, and therefore more deeply rooted in our psyche. The fight-or-flight instinct, which was key to the survival of early man, is one of the oldest emotional responses we have. But as civilization has evolved, so has our ability to apply reason and logic to our circumstances as a counterpoint to our instincts.

Nobel laureate Daniel Kahneman says there are two types of operations in judgments, decisions, choices and behavior: first, operations that are automatic, effortless, implicit and often emotionally charged (the

heart); and, second, operations that tend to be slower, more consciously and deliberately monitored and potentially rule-governed (the head).

Our brains use both of these parts—the head and the heart—to process information, but sometimes the one can overrule the other. For example, a teenage driver hits a patch of ice on the road and starts to skid. His initial heart response is panic, which causes him to slam on the brakes. As his mind steps in to take over, however, the teen remembers to ease up on the brakes, steer into the turn, and downshift—actions that hopefully save him from a crash. Parents everywhere

can be thankful for Driver's Ed classes that help kids prepare to let their rational responses take over from their initial emotional instincts.

The bottom line is, while emotional heart-responses have been hard-wired into our DNA for millennia, we have the ability to step back from those responses and discern what's best.

Can You Trust Your Gut?

Life would be truly easy if we could simply go with our gut to make decisions. Unfortunately, we can't always trust what we see, or what we feel. That's because our emotions sometimes lead us in ways that we don't realize. Why do we play the lottery when the odds are against ever winning? It's because we love to imagine what we would do if we won...we become emotionally attached to the idea and its fun to imagine the possibilities, and therefore we fork over a few dollars. This is called the endowment effect.

Billionaire investor Warren Buffett is known for trusting his intuition and listening to his gut when investing in companies. But that intuition is backed by information. According to biographer Alice Schroeder, Mr. Buffett oftentimes retreats to his office for days, poring over calculations ahead of an investment decision in order to determine with his head whether his gut instincts are right.

Whether we realize it or not, most of us rely on intuition and non-conscious thoughts as part of our decision-making process. Our non-conscious thoughts play a larger role when the problem is complex, when information is ambiguous and changing, and when goals are ill-defined, shifting or competing.² Sounds like investing, doesn't it? Clearly, it can be dangerous to rely on gut instincts when making decisions about something as important as our financial health. Like Mr. Buffet, we need to be aware of our emotions and be on guard for the traps they can lead us into.

The Heart is More Important Than You Think

While there is ample evidence that emotions can be detrimental to short-term decision-making, it's too simplistic to say that our decisions would be better off entirely without them.

In the shorter term, the heart serves an important purpose similar to that of a building's security system. It raises a red flag in response to a perceived threat, and should not be ignored. However, as we know, the heart is not always an accurate judge. Is the threat real or not? Was the alarm triggered because the electricity was interrupted, or is there really an intruder? The head must step in to assess the situation and determine whether action is needed.

But the heart is more than just an early warning system. As proof, neuroscience studies³ of decision-making in patients with damage to the part of the brain that processes fear demonstrated that the patients' lack of emotions caused severe impairments in the quality of their decisions. These patients made choices that led to financial decline, a loss in social standing, and broken relationships with family and friends. Because they were not able to associate negative emotions with past mistakes, they kept repeating the same poor behaviors over and over.

While an extreme case, the study shows that our heart plays an essential role in our ability to make sound decisions and is essential in enabling us to understand what that future impact might look like. Without the heart, we would have no concept of guilt, regret and shame—powerful emotions that serve a valuable role in directing our decision-making. A key part of our ability to make sound decisions consists of comparing a current decision with the emotions and feelings we've experienced from similar, past situations. How many times have you told yourself, "I'll never make that mistake again!" To live up to that promise, your heart reminds you of the negative feelings associated with past mistakes. Associating a strong, negative feeling with a mistake we've made, makes us less likely to repeat it.

¹ Kahneman, D. "A Perspective on Judgment and Choice." *American Psychologist*, 58 (2004), pp. 697-720.

² Montier, J., "The Little Book of Behavioral Investing"; John Wiley & Sons, Ltd, 2010, p. 10.

³ Bechara, A., "The role of emotion in decision-making: Evidence from neurological patients with orbitofrontal damage"; *Brain and Cognition* 55 (2004), p. 30-40.

⁴ Cheng, P. "Improving Financial Decision making With Unconscious Thought: A Transcendent Model". *Journal of Behavioral Finance*, 11:92-102,2010.

Likewise, without the heart, we would be unable to conceive of concepts like happiness, fulfillment and giving back to others. Our emotions are the source of creative ideas that enable us to cast our long-term vision for the future. They help form our values and principles, which are essential to our well-being. The heart keeps wealth in its right place: as the means to fulfilling our life vision.

A Simple Approach to Better Decisions

To make our best decisions, we must be aware of how we are wired, understand our biases and take a balanced approach to decision-making. Philip Cheng⁴, a behavioral finance researcher, believes that our total cognitive decision-making capacity is comprised of both conscious and unconscious parts, and that these two parts complement and compensate for each other.

Cheng suggests these three simple steps to create the opportunity for your conscious and unconscious mind to work together toward better decisions:

- 1. Commit to making the best decision.** While this may seem obvious, it is all too often the case that we put off the work of preparing for decisions until the moment of crisis is upon us. It's best to work on your decision when you are in an emotionally neutral, rational state.
- 2. Sleep on it.** When you think you have your answer, set aside some down-time, pursuing other activities while you allow your unconscious mind to further process and organize your thoughts. Not thinking about your decision gives your mind time to "incubate," which can often lead to new, more creative alternatives.

- 3. Revisit your decision.** Take into account any new thoughts, feelings or ideas that may have arisen during your down-time. Be sure to consider counter-arguments as part of the decision. Only at this point should you take action.

We are all susceptible to emotional biases. Being more aware of whether you are thinking with your head or your heart, and giving yourself time to allow both your conscious and unconscious mind to weigh in on the matter are good first steps toward navigating decisions more effectively for long-term success.

And now you know: Should you make decisions with your head or your heart? Both, as this will lead to a better decision.

At SEI, we integrated the lesson of behavior science into our advice to help our clients make better financial decisions.

About SEI Private Wealth Management

SEI Private Wealth Management provides individuals and families with an innovative approach to wealth management. We provide personally relevant advice centered on your goals across all aspects of your wealth, with access to experts in:

- Investments
- Estate Planning
- Philanthropy
- Asset Protection
- Tax Management
- Financial Analysis and Cash Flow Management

Do you think with your head or your heart? Interested in learning more? Call **888-551-7872** to speak to an SEI Private Wealth Management team member today, or visit us at www.seic.com/privatewealth.

Common Emotional Biases

Do you see yourself in any of these?

	DESCRIPTION	EXAMPLE
Blind Spot	Ability to see emotional biases in others, but not in self.	"I would never do that."
Anchoring	Using erroneous reference points to estimate current level of success or failure.	As the stock price falls: "Well, I bought this company at \$65. As soon as it climbs back up to that level, I'll sell it."
Endowment Effect	Overvaluing an asset due to an emotional attachment.	"My grandfather started this company. It's worth much more than the broker stated."
Fast Thinking	Making quick decisions without all the facts.	"If I don't get in on this deal now, I'll lose my chance forever."
Overconfidence	Being overly optimistic or feeling like you have an edge on everyone else.	"If I can run a Fortune 500 Company, I can certainly manage my own finances. I don't need advice."
Belief Perseverance	Sticking to our guns and hanging onto a view even when new information contradicts our position.	"Yes, the company is in bankruptcy and the CFO has fled the country, but they have a good business model. I just know they're going to come back!"
Confirmation Bias	Looking for information to confirm our decisions, rather than challenge them.	"My friend said it's great and I keep reading about it online, so it must be a good idea."
Availability Errors	Relying on limited information when making decisions.	"Our expenses in retirement? Oh, they won't be that much. We don't spend that much now as it is."
Narrow Framing	Not having a clear understanding of the available options.	Thinking only in terms of "sell" or "don't sell," while ignoring more creative options that may enable you to lower your exposure but also retain some level of control.
Regret	Avoiding actions that could make us feel regret about decisions we made earlier.	Statistics confirm that we hold on to losing investments longer than we keep winning ones. It's hard to admit when we are wrong.
Extrapolation Bias	Weighing recent events more heavily in predictions and focusing on short-term patterns rather than longer-term ones.	"The price of gold has risen for 10 straight weeks. Of course it's going to keep going up."
Status Quo Bias	Delaying or avoiding making decisions due to a lack of information or knowledge about how to make the right choice.	"It would take me hours to try to understand these options. I can't focus on this right now. I'll get back to you later."
Hindsight Bias	Believing after the fact you 'saw it coming' when in fact you did not.	"I knew there was a housing bubble. Why didn't my advisor tell me to get out in time? I should have pulled my money out sooner!"
Mental Accounting	How we organize, evaluate and keep track of our financial activities.	Most people mentally separate their wealth into buckets for different purposes, but unfortunately their invest don't always align with the buckets.

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