Money is one of the most important facets of modern life, yet Americans rank only 14th in the world for financial literacy, behind the Czech Republic, Norway, and Denmark, according to a November 2015 Standard and Poor’s survey. "U.S. adults have a relatively weak understanding of interest even though U.S. credit card use and student debt is among the highest in the world," it said. Fortunately, or unfortunately, financial literacy is higher in the richest 60 percent of American households than it is in the poorest 40 percent by almost 20 percentage points. As financial literacy increases, so does income. If we want to make more money, we need to improve our financial literacy.

Brigitte Madrian, a graduate of BYU's economics program and a professor of economics at Harvard University, spoke on this subject at an October 2016 lecture about household financial decision-making. The recipient of the College of Family, Home, and Social Science's 2016 Alumni Achievement Award, Madrian addressed many common mistakes people make with their money. Here’s a quick look at four of the biggest mistakes to be aware of and what to do about them.
“WHAT ACTUALLY WORKS IS MAKING THE GOOD OUTCOME THE EASY OUTCOME.”

Brigitte Madrian is the Asiah Professor of Public Policy and Corporate Management at the Harvard Kennedy School. Her work on behavioral economics and household finance has impacted the design of employer-sponsored savings plans in the U.S. and has influenced pension reform legislation both in the U.S. and abroad.

The full video of her lecture can be found at fhss.byu.edu under “Lectures.”

Procrastination
The single biggest financial mistake that people make, according to Madrian, is that they procrastinate. Some procrastinate taking part in workplace savings plans, recognizing the utility of such a plan but not actually taking the effort to opt in. Others procrastinate paying their debts, she said, “and still more procrastinate receiving or completing an education, which is the most important financial decision most people will ever make.” And tragically, many procrastinate getting insurance until it’s too late. “People are more likely to buy insurance after something bad happens rather than before something bad happens,” she added. “They don’t buy [flood insurance] before the flood, they buy it after the flood, after they’ve . . . lost a lot of money.”

◆ To counteract that, Madrian says that “what actually works is making the good outcome the easy outcome.” Let yourself be automatically enrolled in your employer’s retirement plan, if they offer one, for instance. Taking Bad Risks
“People are afraid to invest in the stock market even though it’s a pretty good place to put your money, at least for the long term,” Madrian says, calling the stock market “a risk that makes sense.” She adds, “On the other hand, we’ve got people who are more than willing to take risks that don’t make sense, such as gambling, which usually has a negative expected value.”

◆ Madrian notes that risks are an important and valuable part of a financially balanced life, and, in fact, a life balanced in all aspects. “We should take sensible risks,” she says. “All of our investments may not pay off, but if we make enough of them and we’re well diversified, we will come out ahead.”

Falling for Bias
Two common financial mistakes people make are what she calls the status quo bias and the home bias: our tendency to stick with the way things already are and our tendency to invest in things that are closer to us. It’s far more common for someone to invest in a domestic company over an international one, or at least in a company they’re familiar with. “[People] feel much more comfortable investing in companies they’ve heard of,” Madrian said. “Just because you’ve heard of Apple doesn’t mean they’re the best investment opportunity.” Furthermore, because most people don’t possess adequate financial literacy, they fall victim to the status quo bias, keeping things the way they are because of their discomfort in an unfamiliar financial arena.

◆ Don’t participate in employer stock options, which are often poorly diversified.

◆ Do your research.

Chasing Past Returns
“Financial services firms want you to focus on . . . past returns,” said Madrian, “and they don’t pay attention to the things that matter the most, namely, the investment fees that you’re paying.” According to Madrian, past returns are rarely a good indicator of future performance. Nonetheless, people have a tendency to seek investments that have done well in the past, assuming that a good future is likely. In fact, recent literature on the subject has shown that when people sell their stocks to chase past returns, their money would usually have done better where it originally was. “They’re selling the stocks that are going to do good in the future to buy stocks that have done well in the past,” Madrian said.

◆ Find out about the investment fees, or the cost of having your assets professionally managed. They usually range from 1 percent to more than 2 percent of the assets you have invested. Generally, the higher the fee, the more aggressive the manager’s methods and your assumed risk tolerance.

Financial decisions are complicated, and you should expect to make some mistakes. But Madrian offers valuable insight into the most common of these mistakes, thus helping the public to avoid them. Ultimately, she says, “we’re all human, we all make mistakes, and we can all learn from them and do better. I encourage you to make mistakes (and) learn from them.”

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