WHY SMART PEOPLE MAKE MAJOR MONEY MISTAKES MENTAL BLIND SPOTS CAN LEAD YOU INTO FINANCIAL BLUNDERS. HERE'S HOW TO THINK CLEARLY ABOUT MONEY.

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LAST DECEMBER, WHEN UNIVERSITY OF CHICAGO economist Richard Thaler was called to testify before the Senate Finance Committee about the nation's savings habits, his appearance threw a spotlight on a new academic discipline: psychoeconomics. This emerging field is based on the principle that all financial decisions are influenced by seemingly irrational psychological tendencies. Left unchecked, such tendencies can lead even the brightest financial minds to make costly mistakes. For instance, testified Thaler, people don't save as much as they should because of a phenomenon known as mental accounting (see No. 6 below). However, says Thaler, who calls himself a behavioral economist, by studying these mental quirks, we can avoid errors and we can learn to "make our desired behavior automatic."

To help you understand your money motivations, Money canvassed more than four dozen economists, psychologists, investment managers and financial planners to identify the most common psychoeconomic traps that everyone from supermarket shoppers to sophisticated investors faces. Our experts then offered advice on how to sidestep these pitfalls. In addition, we report on four families (see right and pages 76, 80 and 82) who committed some classic goofs -- and learned how to avoid them in the future. Last, we recognize that not all money mistakes stem from psychological factors; some simply result from not knowing the basics of personal finance. Therefore on page 84 we offer a financial IQ test that will help you isolate the fuzzy areas of your financial knowledge and tell you where to go to learn more. First, the psychological quirks:

1 WE FEAR LOSS MORE THAN WE SHOULD.

You've been given a free ticket to an exciting football game. At the last minute, a sudden snowstorm makes getting to the stadium somewhat dangerous. would you go?

Now, assume the same game and snowstorm, except this time you paid handsomely for the ticket. would you go?

Most people are more likely to risk their safety in the snowstorm if they paid for the ticket, according to Thaler. But from a strictly economic point of view, that's irrational. In both scenarios, the choice is the same -- to use the ticket or not.

Two all too human tendencies come into play here. The first is sometimes called the sunk-cost fallacy, meaning that having paid for an item or service can make us overly reluctant to waste it. In the case of the football game, a person who paid for the ticket is more likely to view missing the game as a "waste" than the person who was given the ticket. That's irrational, explains Thaler, because "the fact that you spent $100 shouldn't matter when you decide between the reward of seeing the game and the risk of getting killed."

The second tendency is loss aversion, or the idea that people place about twice as much significance (called utility in economics parlance) on a loss as they do on a gain. In other words, people become twice as unhappy about losing $100 than they become pleased about gaining $100.

Mistakes of sunk cost and loss aversion can be expensive indeed. Just ask New York City writer Lloyd Chrein, 33, who bought a studio apartment in lower Manhattan six years ago for $99,000. When Chrein got married three years later and moved into a bigger place, he tried to sell the studio in what had become a severely depressed real estate market. "I wasn't psychologically prepared for a $20,000 loss," says Chrein, who decided to rent his studio rather than settle for a $79,000 offer. Today, the studio's price has fallen another $10,000. "I got stuck on what I paid for it," he acknowledges, "rather than what it was worth."

THE ADVICE: Evaluate investments solely on their potential for future loss and future gain. Your best bet is to ignore all your feelings about what you paid and calculate only on the basis of current value. Says Thomas J. Mudge III, a senior vice president of the San Mateo investment advisory firm Bailard Biehl & Kaiser, "The question is not, 'Am I sorry I bought this stock for $100?' The question is 'Am I glad to own this stock at $50 today?'"

2 WE IGNORE INFLATION.

John, Ted and Bill each bought houses for $200,000 and ended up selling them one year later. During John's year, there was 25% deflation -- the average price of all goods and services fell by 25%. He sold the house for $154,000, or 23% less than he paid. During Ted's year, there was 25% inflation -- prices in general rose 25%. Ted sold his home for $246,000, or 23% more than he paid. On average, prices stayed the same during the year for Bill, who sold his home for $196,000, or 2% less than he paid. Factoring in the changes in overall prices, which of the three came out best?

In a study conducted by Princeton University psychology professor Eldar Shafir, roughly 60% of 82 participants thought Ted fared best, while 62% thought John ended up with the worst loss. In reality, John was the only homeowner who actually made money. When the rate of inflation is factored into his purchase and selling prices, John posted a 2% gain in buying power. He's the only one who won't have to trade down on his next house.

The mistake made by most of those surveyed is called the money illusion. Translation: People confuse "nominal" changes in money (greater or lesser numbers of dollars) with "real" changes (greater or lesser buying power) that take into account inflation or, more rarely, deflation. "Many of our financial mistakes come from paying attention to the wrong things," explains Shafir. "People tend to focus on nominal amounts because they're easier to grasp even though the real amounts are what count."

Failing to consider the effects of inflation can be dangerous. Many people, for example, willingly give up the greater returns of stocks in exchange for the ironclad security of government bonds held to maturity. A person who invests $10,000 today in U.S. Treasury bonds will have $40,000 in 20 years, assuming a 7% average annual return. While that's $69,000 less than a person who invested 10 grand in stocks over the same period-he would have $109,000, supposing a 12% average annual return -- it's still an impressive amount. But assuming an average inflation rate of 4%, the stock investor would have the equivalent of $49,000 in terms of today's buying power when the year 2015 rolled along, while the bond investor would have a meager $18,000. Says Southfield, Mich. money manager Ron Yolles: "People will lock their money in a bond or CD that earns 7%, and they think they're getting something -- a safe investment with a pretty good return. What they don't realize is that the real threat is inflation."

THE ADVICE: The best way to understand inflation is to think in terms of buying power. Says Yolles: "I tell people to think about what a dollar bought 20 years ago and what it buys today. Then you'll start to understand how the dollar shrinks and how you'll need more dollars than you think 20 years from now."

3 WE THINK EVERYONE ELSE IS AN EXPERT.

Bill and Mary recently bought a new home for $150,000, after checking that the house was solidly built and located in an area with good schools and friendly neighbors. They loved their new digs, but over the next few months a steady stream of people knocked on their door, making smaller and smaller bids to buy their dream home. Now, Bill and Mary are considering selling at a price 50% below what they paid because they're worried something may be wrong with the neighborhood. Should they sell?

We must be kidding, right? What sane person would sell anything under such circumstances? But replace the house in our example with, say, 100 shares of Widget Inc. stock, and a lot of people would advise our couple to sell -- and fast. The mistake here is what Wall Street calls herd investing, or relying too heavily on the opinions and actions of others.

This phenomenon, sometimes called an information cascade, is common everywhere -- in the form of long lines at hot new restaurants or short hemlines on hip new fashions. The actions of a few people lead others to imitate what they do, which in turn leads to even more mimicry by even more people, and so on. Such a snowball effect is a very powerful force, explains Ivo Welch, an economist at the University of California-Los Angeles' Anderson Graduate School of Management. "Even if what you personally observe indicates one thing," says Welch, "the fact that 10 of your friends have decided something else is hard tignore."

Blindly following the crowd can cost you a bundle in the financial markets. For instance: In 1992, when President Clinton began his campaign to reform the nation's health-care system, the share price of blue-chip pharmaceutical giant Johnson & Johnson began an 18-month decline, from $59 to $36, as professional stock pickers soured on all health-care stocks and individual investors followed suit. During that period, however, J&J continued to post double-digit profit growth, mostly thanks to the fact that they manufacture Band-Aids and contact lenses as well as drugs. "People reacted to sentiment about the company," explains Mudge, "and ignored the fact that much of Johnson & Johnson's business wasn't going to be harmed by health-care reform. They ignored the fact that profits were rising and sold anyway."

On the flip side, people often gallop with the herd right into a dubious investment. Rockville, Md. art dealer David Kenny, 48, for example, sank $25,000 in a gas partnership in 1989 because he thought a group of sophisticated investors were about to make a killing. But it was Kenny who got killed (for more details, see the facing page): "I thought it was a sure thing," he says, "because those guys wouldn't invest in something that wasn't."

THE ADVICE: Ignore conventional wisdom and set your own investment guidelines, says Earl Osborn, a partner in the San Francisco investment advisory firm Bingham Osborn & Scarborough: "If you follow the fad, you'll just be whipsawed."

4 WE ARE OVERCONFIDENT.

Quick! How do you pronounce the capital of Kentucky: "Loo-ee-ville" or "Loo-iss-ville"? Want to bet $5 that you got it right?

Here's the catch: The above choices were framed to play on everyone's tendency to believe that what they already know is all they need to know in any transaction -- in this case, that the "s" is silent when saying Louisville. In fact, what you really need to know is that the capital of Kentucky is Frankfort.

The problem here is overconfidence, or people's unwarranted belief in their own abilities. "One classic example of this trap is a 1981 survey that showed that 90% of the automobile drivers in Sweden consider themselves above average," says Werner De Bondt, a professor of finance at the University of Wisconsin in Madison. "Of course, this is statistically improbable. But," he continues, "most people believe they are good drivers."

Overconfidence is a particular trap when people have special information or personal experience -- no matter how limited. That's why so many small investors buy a company's stock on little more information than a "hot tip" or some exposure to one of the company's products or services. Case in point: Au Bon Pain, a nationwide bakery and restaurant chain. Au Bon Pain's stock went from $13.25 a share to $28 within one year of its 1991 initial public offering. "A lot of people liked the company's food and saw that the chain's outlets were busy," says University of Illinois finance professor Jay Ritter. "They assumed that since they were familiar with the company they had expertise in valuing its worth."

But in reality, eating fresh-baked croissants does not transform you into a securities analyst. Despite continued strong sales, Au Bon Pain's stock has recently sunk to $12 a share as ongoing management changes hold down profits.

THE ADVICE: Keep good records of your major investment and financial decisions, including decisions not to buy or sell. Yes, it's niggling and irritating, but even informal record keeping will curb your tendency to overestimate your skills. "If you remember only your victories," explains De Bondt, "you tend to dramatically underestimate the prospect of defeat."

5 WE HEAR ONLY WHAT WE WANT TO HEAR.

Here are guidebook descriptions of two restaurants. Which sounds more appealing? Restaurant A, says the guide, is "one of the creme de la creme in the area." Dinner is served in a candlelit, romantic dining room with carved wood ceilings, marble fireplaces and tapestries on the walls. The menu includes veal marsala, beef tournedos and shrimp scampi. Service is superb. Restaurant B, described as "one of the few restaurants in the area with a national reputation," offers "all of the elements for a fine dining experience." The restaurant has a tastefully appointed dining room and a menu that focuses on seafood and veal but also features some delicious beef and poultry dishes. Entrees include lobster Newburg, veal Madeira and beef Wellington.

Can't decide? That's okay, the descriptions were meant to be similar. Indeed, when Cornell University marketing and behavioral science professor J. Edward Russo gave a group of students a similar set of descriptions, the students found no significant differences between the two establishments.

However, with another group of students, Russo revealed the restaurants' equivalent features one pair at a time -- say, one's "romantic dining room" with the other's "tastefully appointed dining room." Then he asked the students to choose which eatery they preferred. By contrast, these students saw a distinction between the restaurants and were decisive in their preferences. The result was that 84% of the students selected whichever restaurant they had liked after hearing the first pair, even though the descriptions proved them almost the same.

What's at work here is what Russo calls a preferential bias. When people develop preferences, they tend to distort any new information to support those preferences and to discount subsequent data that doesn't. It's why an otherwise cost-conscious investor might ignore the above-average fees or sales charges of a particular mutual fund if the initial appeal of that fund was, say, its above-average returns.

Such willful thinking can interfere with the entire range of financial decisions. For example, retired supply manager Stewart Jansma, 69, from Merritt Island, Fla. always wanted to own his own business. That bias made him miss the warning signs in an investment scam (see page 80 for the details). "I liked what I saw originally," admits Jansma, "and I wasn't careful enough."

THE ADVICE: Before making any significant purchase or investment, make sure you discuss your options with objective friends or experts. "A different perspective might show where you've been kidding yourself," says Russo.

6 WE VALUE SOME DOLLARS LESS.

1) You're given $30 and then offered a chance to flip a coin: Heads you win $9, tails you lose $9. Would you flip? Or: 2) You're given a choice of either getting $30 outright or accepting a coin flip that will result in your winning either $39 or $21. Do you gamble or take the $30 and run?

When behavioral economist Thaler and Wharton School marketing professor Eric Johnson offered one of the above choices to each of two different groups, 70% of those who were given $30 opted to gamble, compared with just 43% of those offered the second choice. That's curious, since the odds are the same in both scenarios: either a sure $30 or a fifty-fifty chance of finishing up with $39 or $21.

Casino gamblers call this phenomenon "playing with the house money." That is, people are more willing to take risks when they perceive that they're gambling with someone else's dough. (The sunk-cost mistake, described above, of course, is similar. You value an item less when you get it for free.) The mistake, says Thaler, is forgetting that a buck is a buck. Such mental accounting, or the tendency many people have to value money differently depending on where it comes from, can often lead to unfortunate consequences. "That's why you have people blowing a big bonus or tax refund on something extravagant," explains Thaler, "when they would never consider taking the same amount out of their savings." Because they perceive that cash as "found money," people tend to spend it more readily.

Moreover, recent research suggests that mental accounting can influence people who buy on credit to pay more than they would if they were paying cash. In an experiment by MIT marketing professor Drazen Prelec and University of Chicago Business School professor Duncan Simester, half the participants in a real-life sealed-bid auction for Boston Celtics game tickets were told that the winning bid would have to be paid in cash. The other half understood that they would pay by credit card. The result: The average credit-card bid was about twice the average cash bid. "People like to compartmentalize money in their heads, and credit cards provide a very effective mental wall," Prelec explains.

That's how engineer Charlie Haupt, 42, and his wife Glenda, a 42-year-old bookkeeper, racked up $24,000 in credit-card debt two years after buying a $98,000 house in 1992 (see page 76). "Credit cards made it easy to go out and buy, buy, buy," says Charlie.

THE ADVICE: When using credit cards, ask yourself whether you'd pay the same price or even purchase the item at all if you were paying cash. With that "found money" from, for example, a tax refund, inheritance or bonus, wait a while before you make any spending decisions. Says Prelec: "The longer you hold on to money, the more likely you are to consider it really yours."

7 WE RESIST CHANGE

You're in the market for a compact disk player and have not yet decided which brand or model you want. You pass a store advertising a one-day sale for a popular Sony player for only $99, well below list price. Do you:

1) Buy the player immediately.
2) Wait to learn more about other models.

Now, imagine the same scenario except that the store is also offering a top-of-the-line Aiwa player for $159, also well below list. Do you:

1) Buy the Aiwa.
2) Buy the Sony.
3) Wait to learn about other models.

When Shafir, the Princeton psychologist, and Stanford psychologist Amos Tversky presented the first scenario to a group of consumers, barely a third said they'd wait before snapping up the Sony. However, when faced with choosing between the Sony and the Aiwa, almost half of the group said they would mull their options. Two related tendencies are responsible. The first is "choice conflict," or the discomfort many people feel when they are confronted with too many options. They worry that they will get the decision wrong.

Because of that worry, another tendency kicks in, which behavioral economists call a "status quo bias." When that happens, people prefer to maintain the present situation-for instance, employees who never change their 401(k) account elections, even though new options are added.

Another example: When special-education teacher Trish Sawrey, 46, went shopping for health insurance, the Huntington Beach, Calif. mother of three opted for a fee-for-service plan rather than a less expensive managed-care plan (see page 78). "I did not want to change doctors," says Sawrey, "but I ended up paying a lot more than I thought I would."

THE ADVICE: When choosing among new options, "people need to remember that deciding to do nothing is still a decision, and potentially a bad one," says money manager Yolles. "Sure, choosing among 4,000 mutual funds is daunting. But leaving your money in the bank paying 4.5% interest is no solution."

8 WE BITE OFF MORE THAN WE CAN CHEW

Which is a better deal?

1) A three-course meal for $18; or
2) Unlimited eats at a buffet table for $22

That, of course, depends on how hungry you are. Yet many people blindly choose all-you-can-eat sorts of bargains without considering their real needs or desires. And that's the mistake-confusing a big deal with a good one.

When products and services are bundled to sell as a package or are sold at a discount or in great bulk, are you always getting value? Frequently, says Cornell economist Robert Frank, the answer is no. On the one hand, even when the total cost of the component parts is indeed higher than the bargain price of the package, "people are generally never able to use all the things that are covered by the one price," says Frank.

On the other hand, consumers often come out ahead when they buy component parts of a package separately. For example: Variable life insurance policies offer insurance and mutual-fund-like investment components in one package. But "people would be better off buying a cheaper term insurance policy," says Bellevue, Wash. financial planner Craig Noel, "and investing the balance independently in mutual funds."

THE ADVICE: Break every package deal into its component parts and make sure that you want each and every feature. Even if you do, make sure you can't get the parts you want for less.

A final note: When correcting your money mistakes, remember that some solutions can be worse than the problem. An investor prone to loss aversion or the sunk-cost fallacy, for instance, might overcompensate by selling shares too soon. A slight dip in price isn't always a reason to sell. Says Los Angeles money psychologist James W. Gottfurcht: "The idea is to bring about a new way of thinking about and handling money. A quick fix, without thoroughly understanding the potential consequences, will lead to compounding your mistake."