FINANCIAL PLANNING

Personal financial rules that help stop you from spending too much money

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When Lisa MacColl, a freelance writer from Kitchener, Ont., gets hit with the craving to go shopping, she visits her favourite online knitting store and loads up a virtual cart. Then, once the self-professed emotional buyer feels her consumerist desire fade, she dumps the whole lot and gets back to her day.

She hasn't spent a dime.

"For some odd reason, it satisfies the shopping urge without nailing my bank account in the process," she says.

Like Ms. MacColl, many of us play simple mind tricks on ourselves and create rules to save money, whether at the checkout counter or in our bank account. We might decide to never shop on an empty stomach or only buy used toys and clothing for our children until they actually notice. A Costco customer decides she will forgo a push cart while shopping there so she's not tempted to overspend. Her rule: If she can't lift it, she won't buy it.

Many behavioural economists and financial planners believe these simple rules can make life less taxing and create good financial habits. They even use a word lifted from psychology to describe them: heuristics.

Traditionally, heuristics are seen as simple, efficient mental shortcuts everyone uses when making decisions throughout the day. They're often intuitive and people may not even be aware they're using them. Until the past decade, heuristics have been in the realm of academics and researchers, but more recently they've entered the personal finance lexicon, too.

In short, if people can harness the power of all those quick, subconscious rules of thumb, they can apply them to purposeful rules to save money by.

Simple rules makes a lot of sense, says Claire Tsai, an associate professor of marketing and a behavioural economist who researches decision making and problem solving at the University of Toronto's Rotman School of Management.

"It's hard, when faced with temptations, to think about the pros and cons of saving for retirement. It's just not possible," she says. So it makes sense, she says, to develop a way to block temptation and be able to make financial decisions while in a rational state.

Noel D'Souza, a money coach with Money Coaches Canada and a certified financial planner in Toronto, says many of his clients come up with heuristics to help cope with buying decisions. For instance, the person who will only buy an electronic device if he has done some research on that particular model.

"It makes them less susceptible to impulse shopping and being talked into a purchase by a salesperson. The rule puts a little bit of distance between an item and a purchase decision," he explains.

Mr. D'Souza uses a heuristic principle himself: Never invest in a company that isn't making a profit right now. He decided to create the rule after losing money in the dot-com crash 15 years ago. In that case, he has a lot in common with those who use personal finance heuristics.

"I find that people often put these rules in place after they've gotten themselves into trouble," Mr. D'Souza says.

Not that connecting emotion to the rule is necessarily a bad thing. He believes that a painful experience can make the rule stick when others might not. There is more weight behind it.

Stephanie Holmes-Winton, founder of the Certified Cash Flow Specialist designation program in Halifax, teaches financial advisers how to build heuristics into their clients' plans. Another good way to ensure their success is to tie the rule to a related reward. For instance, people whose heuristic principle is to spend no more than $100 a week on groceries might also build in another rule – if they spend less than that, they can use the extra cash to buy a favourite coffee.

In another case, a family might decide it will save money on its next car by shortening the payment timeline to just 36 months, rather than the more typical five or seven years. If they family members walk out of the dealership with the deal, and stick with the plan, they agree to go to Disney World or take a beach vacation with the freed-up cash. Better yet, get the whole family on board and bring the children along for the negotiations.

“There’s nothing like a seven-year-old staring down the business manager at the dealership and saying, ‘No. We want 36 months,’” she says.

There are negative sides to heuristics as well, particularly when the rule is unrealistic or inflexible. Having one that states you will spend less than $2 on a bag of oranges could mean you drive from grocery store to grocery store each week looking for cheap ones – and eat up $5 of your gas budget. Nor does it make sense to use up the family grocery budget to pay for expensive medication because you refuse to use your credit card for anything more than $30.

It’s also important to put limits on heuristic rules, says Mr. D’Souza, or you might be tempted to skirt around them in creative ways.
“Say you’re not going to spend more than $50 on a pair of shoes. That doesn’t mean you can go out and buy 10 pairs of $45 shoes,” he explains.

Yet perhaps the biggest threat to developing a solid financial heuristic is our own biases and emotions. Ms. Holmes-Winton points to a typical investors’ rule that supports dumping an investment if the stock drops below a predetermined level.

“That’s the worst trigger for selling anything,” she says.

Instead, investments should only be sold if they no longer fit a risk profile, if there’s been a negative change in the company, or it’s simply time to cash out because the financial goal has been reached.

“Be careful that your heuristic principles are not supporting irrational fears or behaviours that cost you money,” she says.