STUPID NUMBER TRICKS by Jason Zweig

When college students were asked which was riskier, a kind of cancer that kills 1,286 out of 10,000 people it strikes or one that kills 12.86% of them, the students rated the first kind about 20% more dangerous. A knock on college kids? Not really. Our perceptions are so dominated by our emotions that a small change in the way a risk is presented to us can have a big impact on how scary it seems.

"Equivalent ways of describing something should lead to equivalent judgments and decisions," says University of Oregon psychologist Paul Slovic, an authority on how we assess risk. "But it's not true. People's judgments about risk are very movable and subjective."

When researchers told psychiatrists that "20 out of every 100 patients similar to Mr. Jones are estimated to commit an act of violence" within six months of being released from a mental hospital, only 59% said they would release him. But when told that "patients similar to Mr. Jones are estimated to have a 20% chance of committing an act of violence," 79% said they'd release him. What's going on? Vivid imagery lights up our emotions, shoving analysis aside. As Slovic puts it, "If you tell someone that something will happen to one out of 10 people, they think, 'Well, who's the one?'"

WHICH IS RISKIER?

CHANCE OF BAD OUTCOME
1 IN 5

OR

CHANCE OF GOOD OUTCOME
80%

You may act differently if your financial adviser tells you that you have an 80% chance of hitting your retirement goals than you will if he tells you that one out of five people in your situation ends up eating cat food. Either way, he's given you the same number.

Emotional responses to data also trip us up when we try to assess benefits, studies show. Workers are happier getting a 7% raise when inflation is at 5% than they are receiving a 5% raise when inflation is running at 3%. Shoppers think they're getting a better deal at a two-for-one sale than at a 50%-off sale. And investors get giddy over stock splits even though the value of their holdings doesn't change. Here's how you can stop playing number tricks on yourself in your own investing.

› **Look at lots of data.** When you shop for a stock or mutual fund, don't rely on "average return" or get sucked in by a big cumulative number like a return of 2,900% over 10 years. That would be the return on Dell's stock, which is *down* 15% during the past five years.

› **Get a second opinion.** It's hard to get impressive-sounding numbers out of your head. Ask someone you respect to look at the data too before you decide to buy.

› **Sleep on it.** Your short-term moods can wreak havoc on your judgment of long-term risks. So wait a day before a final decision.

FEAR No. 5

The Housing Bubble Pops

REAL DANGER You're in over your head

IF THE BURSTING of the tech bubble is seared into your memory, you'll tend to call up that readily available interpretive scheme as you analyze the surge in housing prices. Result: You see a giant ball of air. That would be an eminently sensible conclusion—if houses were stocks. Of course, they're not; they're bought and sold in particular local markets and infrequently traded and, well, you live in them.

On the other hand, if you're using interest-only financing to snap up condos in Fresno because you "know from experience" that this market only rises, good luck. Markets can suffer precipitous declines—ask anyone who bought in Massachusetts in the late 1980s. Even Alan Greenspan, a man utterly free of alarmist bias, recently warned that "the housing boom will inevitably simmer down" and that prices could fall.

The real bubble, though, isn't in housing but in housing finance, says strategist Ed Yardeni of Oak Associates. Variable-rate, interest-only mortgages have seduced people into buying more house than they need. (See "Crazy Loans: Is This How the Boom Ends?" on page 53.) Most at risk? Those who bought in late and are stretching themselves even to make their IO payments. "These people could be in some serious trouble," says Yardeni, if interest rates rise or home values fall even on a modest scale.

WHAT TO DO

› **Downsize.** If you've used an interest-only loan to buy a McMansion when you can really only afford a three-bedroom split-level, get real. You're not building any equity, and if prices decline and you have to sell, you'll end up owing the bank. Also, if you're at a point in life when a smaller house is starting to look good, move now and secure your gains.

› **Think about what can go wrong.** If you're counting on home equity to provide for your retirement, ask a financial adviser to assess what will happen to your plans if your home's value drops by 10%, 20% or 30%, says Joe Davis, a research analyst at Vanguard.

› **Look at locking in.** The gap between variable and fixed-rate loans has been narrowing as the Fed pushes up short-term interest rates. So grab a fixed rate of interest now. Waiting could add hundreds of dollars to your monthly payment.