

Peccadilloes: Loss Aversion

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The Psychology of Viewing the Pain of a Loss as Greater than the Pleasure of an Equal Gain

Investments don't always go straight up; by definition, investing involves the inevitable risk of loss. Accordingly, one of the most important aspects of successful investing is strategizing our response to loss.

Behavioral finance provides us with the psychological perspective on these responses, as in this classic description of loss aversion:

- **Problem 1:** You have \$10,000 and must choose between two options. Option A guarantees you will receive an additional \$5,000. Option B offers a 50/50 chance either to receive an additional \$10,000 or receive nothing. Which do you choose?
- **Problem 2:** You have \$20,000 and must choose between two options. Option A guarantees you will lose \$5,000. Option B offers a 50/50 chance to either lose \$10,000 or lose nothing.

Scientific research shows that most people choose option A in the first problem—the sure gain, but choose option B in the second problem—a chance to avoid a sure loss. Mathematically, the outcomes for options A and B in both problems are the same; but decision making is influenced, psychologically, by whether the choice is framed in terms of gains or of losses.

Whether we view the glass as being half-full or half-empty leads to asymmetrical thinking and can cloud our judgment surrounding investment decisions. Prospect theory demonstrates that, in our financial decision-making, we tend to focus too heavily on the absolute values of gains and losses, and not sufficiently on the context of the decisions in relation to our overall wealth.

Practical Applications

Loss aversion clouds our investment decision making in at least three important ways.

Being Too Conservative for the Long Term

First, it tends to make us overly conservative in undertaking a long-term strategy; favoring conservative investments—such as CDs, bonds, and annuities—over riskier, but potentially more rewarding investments such as stocks. Even with a long time horizon, we tend to underweight the risk of inflation versus the volatility risk of the stock market.

Summary: How Do You Manage Financial Loss?

Psychologically, we have a stronger drive to avoid a loss than we do to seek a gain of the same size. This drive can significantly impact our financial decision making—from being too conservative to hanging on too tightly to a loss that should be let go.

Being aware of loss aversion and how it affects our decisions can reduce the negative impact this peccadilloe has on our financial plan.

Prospecting Our Losses

Back in the dark ages, I studied expected utility theory as part of microeconomics. According to traditional economics, rational people rank their preferences based upon known values—or “utils”—assigned to different choices. A rational person offered an equal choice between a “100 utils” ice cream sundae and a “25 utils” granola bar will choose the sundae.

But life isn't that simple. We don't always know the value of the outcomes of the choices we have to make. Decision making often occurs in an environment of uncertainty, where we must assess, in advance, the possibility or probability of an outcome. Israeli-born professors Daniel Kahneman (Princeton University) and his research cohort, the late Amos Tversky (Stanford University) introduced this revelation as “Prospect Theory” in a 1979 paper.

The concept of loss aversion is drawn from this groundbreaking material, for which Kahneman won the Nobel Prize in Economics in 2002.

Panicking Because We Don't Understand Our Risk Tolerance

A second influence of loss aversion is that it makes us prone to panic selling. According to Warren Buffet, the key to being a successful investor is to keep your head while everyone else is losing theirs.

In a bear market, loss aversion implicates our ability to maintain exposure to volatile asset classes, the higher expected returns from which are necessary to achieve our financial goals. Since it is impossible to successfully time the market consistently—being in when it's going up and out when it's going down—our attitude must accept the rollercoaster ride.

At the same time, we need to understand as completely as we can our risk tolerance—e.g., can we actually sleep knowing that our retirement fund has lost 10% in the past month?—and be sure that our investment plan is in accord with that risk tolerance.

Attempting to Avoid Losses that Have Already Happened

Finally, and ironically, is the related “sunk cost fallacy” which inhibits us from taking losses we *should take*. Often we hold on to *individual* losing positions—either in a stock or a piece of real estate—waiting to get back to even. In fact, the price we paid for something has absolutely no bearing on whether it is currently a good investment. Paper losses are not real, psychologically, until they have been booked. So we are prone to avoid the loss—which would actually allow us to rationally redeploy our capital based on a clean slate.

Many investors believe success is born from picking the best stocks or identifying hot funds, managers or sectors. It's not. Rather, the secret is managing our behavior in the face of the emotional and cognitive susceptibilities that are part of human nature.