INVESTORS AND THEIR DECISIONS (4)

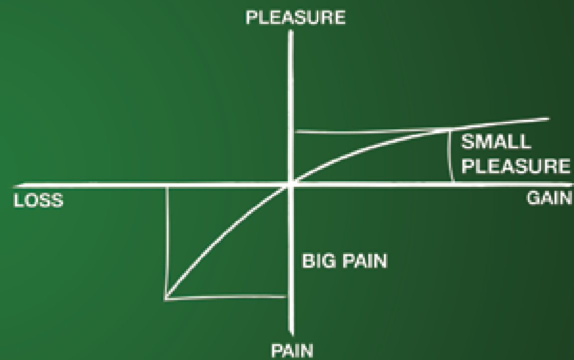
A series of articles, this one being the 4th, addressing investors and their decisions. In particular, whether other factors than rational considerations play a role in the investment decision process, and if so, what the practical consequences and applications are for investors. This article addresses Emotional Biases.

An **emotional bias** is a distortion in cognition and decision making due to emotional factors (1).

EMOTIONAL BIAS: BEWARE OF AVERSION OF LOSS!!

Loss Aversion

Studies have shown that the pain of a loss is almost twice as strong as the reward felt from a gain



(2)

LOSS AVERSION IN ACTION

Consider these two problems (3):

Problem 1: Which do you choose?
Get $900 for sure OR 90% chance to get $1000

Problem 2: Which do you choose?
Lose $900 for sure OR 90% chance to lose $1000

Most likely, if you are like the thousands of respondents before you, you will have selected the “$900” risk-averse option in problem 1.

Most likely though as well, you will have selected the “90% chance to lose $1000” gamble option in problem 2.

How come? This is the explanation of Nobel prize winner Daniel Kahneman, in his widely acclaimed book “Thinking Fast and Slow" (4). It is the central theme in what is known as “prospect theory” and it has considerable implications for investors. In Kahneman’s words:

“The explanation for the risk seeking choice in Problem 2 is the mirror image of the explanation of risk aversion in Problem 1: the (negative) value of losing $900 is much more than 90% of the (negative) value of losing $1000. The sure loss is very aversive, and this drives you to take the risk.”

Hundreds of experiments have been done, on these lines, all leading to similar conclusions. This has led Kahneman to say that "Losses are weighed about twice as much as gains in several contexts".

That we humans are highly motivated to avoid loss (read: pain) is not new. Skinner's traditional psychology (behaviourism) also noted that humans (like animals) will move away from any stimulus causing pain and will move toward any stimulus offering rewards. Where behavioural finance brings in a new element is that avoiding losses outweighs seeking gains significantly.

LOSS AVERSION AND THE NEGATIVE IMPACT ON INVESTORS

Here are some examples of how the bias of loss aversion can have a negative impact on investors and their decisions:

- Hanging on to losing investments, when better, alternative options are available;

  Taking profit on profit making investments rather than realizing losses on loss making investments, even when the profit making investments have better prospects than the loss making investments (disposition effect);
- Investing additional resources in a losing account when better investments are available (sunk-cost fallacy);
- Selecting funds which have not shown any downside (only to experience the downside once participating).

THE LETHAL COMBINATION OF LOSS AVERSION AND NARROW FRAMING: FOLLOWING INVESTMENTS DAILY AND EXPOSING YOURSELF (UNNECESSARILY AND WITH NO USE) TO LOSS AVERSION

It is a fact of life that financial investments go up and down (stocks more than bonds, individual securities more than indices and so forth). Investments fluctuate. The level of fluctuation is often taken as the measure of risk.

So, investors who follow their investments daily are going to experience both gains and losses on an almost daily basis. If they take a broad "frame", like the professional trader, there is no problem. The professional trader expects (or so he should) the daily ups and downs and is not emotionally affected. However, the amateur, the private retail investor, may use a "narrow" frame, focussing on the now. In that case (according to prospect theory) he will be far more affected by the daily losses than the daily gains and will be prone to taking counter productive actions such as churning one's portfolio.

This is what Kahneman says on the matter (5):

"Closely following daily fluctuations is a losing proposition, because the pain of the frequent small losses exceeds the pleasure of the equally frequent small gains. Once a quarter is enough, and may be more than enough for individual investors".

In short, this is the message of behavioral finance: loss aversion is not helpful to participate in the superiors gains financial markets over time offer to private investors. For this reason: investors beware of inversion to loss!

RISK AVERSION IMPACTS GOLFERS AS WELL!

Prospect theory predicts that our stronger motivation to avoid losses than to achieve gains would show up in golf as well (6). Golfers near the hole are confronted with a choice: to putt to avoid a bogey (loss) or to putt to achieve a birdie (gain). This was tested by two economists (Pope and Schweitzer) (7). More than 2.5 million putts were tested (including those of Tiger Woods). The result: whether the putt was easy or hard and at various distances from the hole, players were more successful when putting for par than for birdie. The conclusion (8) being that sub-consciously golfers in order to avert loss (bogey) put in just that bit more extra-concentration.

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Notes:

(1)From Wikipedia

(2) From "When averting loss can lead to averting gains", 11 October 2012, Beyond Bulls&Bears, Franklin Templeton Investments

(3, (4), (5), (6), (7), (8) From "Thinking Fast and Slow" by Daniel Kahneman, Penguin Books, 2012