Loss Aversion: Friend or Foe?

Can attempting to limit losses actually result in more losses?

BY GREG FORSYTHE

"We often sell winners too soon **because we're afraid** they might drop and become losers."

Warren Buffett, perhaps the greatest investor of our time, once advised investors, "Rule number one: Never lose money. Rule number two: Never forget rule number one." Investing always involves the risk of loss, so *never* losing money is unrealistic. I take Buffett's quote to mean that conducting thoughtful research before making an investment decision may help reduce the probability of subsequent losses. But can too much focus on losses potentially lead to poor investment decisions?

What is risk?

In the investment world, risk is generally measured in terms of price volatility. By contrast, Webster's dictionary defines risk as "the chance of injury, damage or loss." While seemingly different, these definitions of risk have some overlap. Investments with more volatile prices, such as stocks, are more likely to generate losses than investments with more stable prices, such as bonds. This risk tends to be particularly acute for short periods of time.

But measuring risk as volatility has its drawbacks: Volatility ignores trend. Buffett also once said, "I'd rather have a lumpy 15% return on capital than a smooth 12%." He meant to emphasize the fact that an average return of 15% compounds to far more wealth over time than does a 12% average return.

But more importantly, volatility ignores direction. Up and down price changes are treated equally in computing volatility, so a stock that steadily falls in price would be deemed no more risky than a stock that steadily rises in price. Not only does this "equal" risk assessment defy common sense, it's also inconsistent with human behavior.

Gains vs. losses

Finance theory accepts that investors may have different risk tolerances, but assumes that investors prefer more return per unit of risk or less risk per unit of return. Behavioral finance research has found that people weigh the prospect of loss much more heavily than they do the prospect of gain. Investors aren't just risk-averse—they are extremely loss-averse.

In his best-selling book, *Thinking, Fast and Slow*, Nobel Prize winner Daniel Kahneman offers many examples of loss aversion at work. Let's take a look at two of these scenarios.

First, imagine you are offered the opportunity to flip a coin one time. You win $150 if you call heads or tails correctly, but you pay $100 if you are wrong. Would you flip the coin? If you said no, you're in good company. Despite equal odds, most people refuse to play because the prospective pain of losing $100 outweighs the potential thrill of winning $150.[1]

Second, let's look at how loss aversion can influence our perception of a situation. Consider the following two gambles. The first requires you to pay $5 for a lottery ticket with a 10% chance of winning $100 and a 90% chance of winning nothing. The second offers you a 10% chance to win $95 and a 90% chance of losing $5. Note that these two gambles are equivalent—you'll end up either $95 richer or $5 poorer. But far more people are willing to take the first gamble than the second because the second gamble more vividly describes what they might lose.[2]

The truth about loss aversion

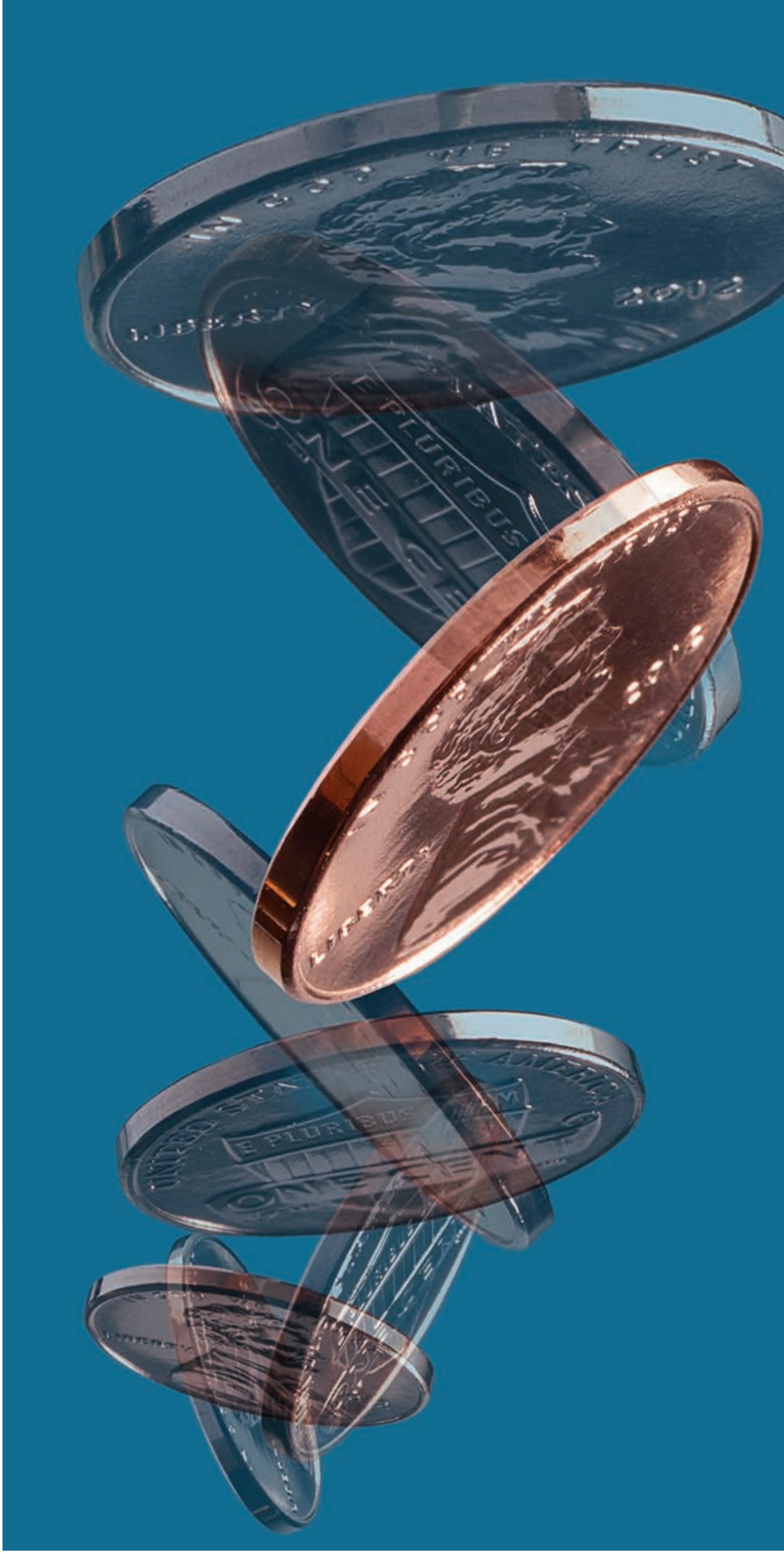
Given Buffett's admonition to "never lose money," you might conclude that having a strong sense of loss aversion would make you a better investor. Maybe, and maybe not. Although successful investing requires thoughtful consideration of downside risk relative to upside potential, excessive loss aversion might deter an investor from venturing beyond bonds or certificates of deposit, even though both have historically underperformed stocks over time.

A subtler—but still dangerous—threat to long-term wealth accumulation is being unaware of how loss aversion can repeatedly trigger sub-optimal decisions. For example, researchers have found that investors tend to sell too quickly those stocks that have gone up in price and hold on too long to stocks that have dropped in price. This behavior is called the "disposition effect" and is attributable to excessive loss aversion.

We often sell winners too soon because we're afraid they might drop and become losers. Conversely, we hold losers too long because we hate to realize losses and cling to the hope that the stock might eventually become a winner. Taking gains quickly might seem like a reasonable strategy, but researchers have found that the stocks investors sell significantly outperform those that they buy over the following year.[3]

Rules of engagement

Limiting losses is a key element of any successful investment strategy. But so is avoiding mistakes that stem from loss aversion. Here are some suggestions to help avoid mistakes:



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1 Have realistic risk expectations. Understand that no investment is risk-free and that you will lose money some of the time. If the stock market falls 20%, your equity portfolio almost certainly will be down, too. Even investments with little price risk, such as Treasury bills, expose you to the risk of not keeping up with inflation.

2 Develop a sound strategy. Whether you use an advisor or invest on your own, employ an investment strategy that is consistent with your goals and risk tolerance. A strategy that you fully understand and believe in is much easier to stick with through those inevitable losing periods.

3 Avoid volatile investments. Securities with volatile prices are more likely to show large short-term losses, potentially triggering emotions that lead you to "buy high and sell low," or to hang on to a losing investment whose fundamentals have deteriorated. Some good news for stock investors: Research has shown that less-volatile stocks have historically provided higher long-term returns than more-volatile stocks.[4]

4 Have a sell discipline. Before making an investment, decide what events would make you want to sell that investment in the future. If one of those events occurs, sell the investment regardless of whether you have a gain or loss. Also consider getting some independent advice. For example, stocks rated D or F by Schwab Equity Ratings® have historically underperformed the average-rated stock by a wide margin, so selling poorly rated stocks could be a sound strategy.

5 Focus on portfolio performance, not individual positions. A diversified portfolio is designed to hold investments that zig and zag at different times, which means you'll almost always have some losing positions. For example, a solid stock selection strategy in which 60% of the individual stock picks outperform in an average one-year period also means 40% of the stock picks underperform. That may sound like a lot of underperformance, but our research shows that, due to the effects of diversification, a portfolio of 20 such stocks has less than a 25% probability of underperforming in the average year.[5]

6 Don't evaluate your investment portfolio every day. The more often you look at your portfolio, the more likely you'll see something going down in price and expose yourself to loss-driven emotions. During the past 75 years, the S&P 500® Index has been down in 46.2% of all days, but that falls to 40.0% when you look at all months and only 29.8% when you look at all years.[6] ■

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[1]Daniel Kahneman, *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux, 2011), p. 283.
[2]Kahneman, *Thinking, Fast and Slow*, p. 364.
[3]Terrance Odean, "Are Investors Reluctant to Realize Their Losses?" *The Journal of Finance*, October 1998.
[4]Andrew Ang, Robert J. Hodrick, Yuhang Xing and Xiaoyan Zhang, "The Cross-Section of Volatility and Expected Returns," *The Journal of Finance*, February 2006.
[5]Schwab Center for Financial Research.
[6]Bespoke Investment Group, as of August 2, 2013. Data indicates how often the S&P 500 declined in price for each of the time periods mentioned (on a rolling basis).

See page 2 for important information.