INVESTING

The truth is humans are terrified of loss

MICHAEL FIELD
Product Development Manager, FedGroup

Bad investments–when to stop and why it's so hard

So often, even when an investment vehicle is underperforming, we choose to stay invested. Sometimes, investors even increase their investment to try and recoup their losses, despite clear, rational reasons as to why they should rather cut their losses and move on.

This behaviour exhibits one of the most prolific ways in which investors erode the value of their retirement savings or limit their long-term investment's potential for growth. It is a concept that behavioural economists have termed the *sunk cost fallacy.*

The justification for increased investment in a decision tends to rise proportionately based on the cumulative value of the investment to date, even when all available evidence suggests that the cost of continuing outweighs the expected benefit.

The truth is humans are terrified of loss. This fear, however irrational, is ingrained into our psychology and it often causes us to make poor decisions.

There is a simple reason for such behaviour: once we invest time and/or money into something the idea of losing it can often result in a slew of irrational decisions. This is a form of loss aversion, another important concept behavioural economists use to explain human behaviour in terms of investment decision-making.

To better understand the psychology behind this decision-making process, it is worth considering a few of the more common irrational decisions that are fuelled by the sunk cost fallacy. It is one of the main reasons why people tend to overeat when they go to restaurants. Once you've paid for a meal you can't get your money back for the food you don't eat. So, to get the full value, be it real or perceived, you may overeat and end up feeling uncomfortable or even sick. In this instance you would've been better off cutting your losses and leaving what remains of your meal.

To overcome the urge to keep eating or avoid throwing good money after bad, to quote a popular investment idiom, it is a good idea to consider any decision in this regard in terms of future outcomes instead of justifying it based on past actions or circumstances.

Taking this approach would mean that if you found yourself standing in a queue for an hour you wouldn't decide to continue to wait simply because you'd been there so long already. What you should rather do is look at how much longer you're likely to still be in the queue and weigh that up against the time and effort it would take to come back the next day. If the latter is a better, more efficient use of your time, then it is best to write off the hour already spent in the queue and try again. Waiting there for another hour or more doesn't justify the time already spent there.

When you apply this thinking to your investment strategy it makes it easier to determine when it's time to cut your losses. For instance, if you bought a share at R20 and it is now worth R15, and you ignore the fact that you already own it, you should ask: "Would I be willing to pay R15 for this share now?" If the answer is 'no' then you clearly believe that it's worth less than R15 and you should sell it. There are, of course, tax implications and other cost factors that need to be included in this example, but the principle behind the decision remains.

This aversion to loss is a deeply ingrained emotional concept that perpetuates the sunk cost fallacy. These psychological phenomena make it difficult to overcome the thought of imminent loss or the idea of being worse off. At the end of the day, it is always better to lose a relatively small amount in the context of a lifetime of savings than lose everything based on an irrational fear. With that in mind, successful long-term investing often hinges on our ability to remove emotion from our decisions.

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