

Mind Over Matter

We like to think we make financial decisions only after clear, rational thought. The reality is that many such decisions are based on the quirky ways we think about risk and reward.

There's even a field of study, called behavioral economics, that analyzes why people think about money as they do. The foundation of behavioral economics is "prospect theory," formulated in 1979 by Nobel Laureate Daniel Kahneman and fellow economist, the late Amos Tversky.

Going for the Sure Gain

Prospect theory concludes that while making money is important to us, not losing money is even *more* important.¹

One study by Kahneman and Tversky asked people to pretend they had \$1,000 to invest. Would they rather have (a) a sure \$500 gain, or (b) a 50% chance of gaining another \$1,000 and a 50% chance of gaining nothing? Eighty-four percent picked (a), taking the modest but certain gain over the risk of gaining nothing.

Then they were asked to imagine they had \$2,000 and to choose between (a) a certain loss of \$500, or (b) a 50% chance of losing \$1,000 and a 50% chance of losing nothing. Nearly 70% picked (b), favoring the risk of losing \$1,000 over the certainty of losing \$500.

Both situations actually yield the same result. If you pick "a" in both cases, you have \$1,500; if you pick "b," you have a 50/50 chance of having \$1,000 or \$2,000. The difference is that one question is seen in terms of gain and the other is seen in terms of loss.

This aversion to loss shows up in real life examples. A 1998 study of brokerage house records of 10,000 individuals by economist Terrance Odean of the University of California, San Diego, showed investors tending to settle for modest profits by selling winning stocks too quickly and to avoid acknowledging losses by holding losing stocks too long.²

Putting the Results Into Practice

Consider that not all your financial decisions may be rational. Give yourself time to think before selling off a winning investment— and think through your reasons for hanging on to a losing one.

¹Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision Making Under Risk," *Econometrica*, 1979.

² Terrance Odean, "Are Investors Reluctant to Realize Their Losses?" *Journal of Finance*, Vol. LIII, No. 5, October 1998.