

Loss aversion could be a very costly human quirk

Hilliard MacBeth

Hilliard's Weekend Notebook - Friday April 13, 2018

Loss Aversion is the human preference to avoid taking losses.

This powerful force can cost people a great deal of money when it comes to trading stocks and buying and selling real estate.

Can humans overcome their desire to avoid taking losses?

I wrote about "loss aversion" as it comes into play when trading stocks in my 1999 book, "Investment Traps" and again, with reference to houses, in "When the Bubble Bursts: Surviving the Canadian Real Estate Crash".

Now that house prices are falling in many parts of Canada, people's aversion to taking losses will become important again.

When people think about the necessity of selling a stock or a house at a loss they tell themselves:

"We'll just hang on until the market settles down and we get our price".

The price is their "anchor" price. Often, it's the purchase price that was paid, but it could be any price that is important to the seller.

Daniel Kahneman, behavioural economist and psychologist, studied this attitude extensively. He found that humans were particularly challenged in "mental accounting". Terence Odean (one of Kahneman's students), examined human decision-making when it comes to stock market trading.

Odean's 1998 study of 10,000 brokerage accounts showed that people were **twice** as likely to sell a stock for a gain as they were to sell a stock for a loss.

In that study this mental quirk cost people a lot, lowering their annual return by about 4.4% per annum — a large amount when stock market returns averaged about 7% per annum.

For more than 25 years I acted as an advisor who suggested buy and sell ideas to clients, but the client made the final decision. Clients almost always said "yes" to suggestions to take a profit.

OUR PARTNERS

The Mac Beth Group

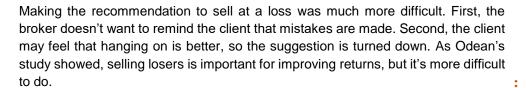
Richardson GMP 10180 101 Street, Suite 3360 Edmonton, AB T5J 3S4

Tel. 1.780.409.7735 Fax 780.409.7777

www.TheMacBethGroup.com

Hilliard MacBeth

Director, Wealth Management Portfolio Manager **Tel.** 780.409.7740



In this example, the anchor price is the price paid for the stock and the investor wants that before agreeing to sell. But the anchor price shouldn't be as important as the prospects for the company. If the company is getting into trouble, it's important to sell, regardless of the anchor price.

"A rational investor is interested only in the future consequences of current investments". Kahneman *Thinking Fast and Slow 2011*

This reminder seems timely given the recent change in direction in house prices. Vancouver home prices peaked in 2016 while Toronto prices peaked in 2017. But today's prices are still, in most cases, nearly triple what prevailed 20 years ago. It should be easy to sell. But people won't because of their anchor price. In this case, the anchor price is different from the stock market example. The anchor price might be what could have been obtained if the house had been sold near peak prices. Loss aversion comes into play because they are selling below peak profit, which has become their anchor price.

It's difficult to sell a home today, when finding a buyer means cutting the price drastically from what it was just a year ago. But if prices are likely to be declining for several years, then it could be the right thing to do. It might take several years for home owners to accept that peak prices are gone.

People thinking of buying could be rewarded for waiting until the market becomes rational again.

Hilliard MacBeth

The opinions expressed in this report are the opinions of the author and readers should not assume they reflect the opinions or recommendations of Richardson GMP Limited or its affiliates. Assumptions, opinions and estimates constitute the author's judgment as of the date of this material and are subject to change without notice. We do not warrant the completeness or accuracy of this material, and it should not be relied upon as such. Before acting on any recommendation, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. Richardson GMP Limited is a member of Canadian Investor Protection Fund. Richardson is a trademark of James Richardson & Sons, Limited. GMP is a registered trade-mark of GMP Securities L.P. Both used under license by Richardson GMP Limited.



