Loss aversion could be a very costly human quirk

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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.

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Making the recommendation to sell at a loss was much more difficult. First, the broker doesn't want to remind the client that mistakes are made. Second, the client may feel that hanging on is better, so the suggestion is turned down. As Odean's study showed, selling losers is important for improving returns, but it's more difficult to do.

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.

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