Investment Decision Making

May 13th, 2011

Dear Friends,

In the past, we have presented you with some educational materials associated with behavioral economics and investment decision making. In this document, we try to sum up some research and we explain a comprehensive approach to investment decision making from the perspective of behavioral finance.

We first briefly discuss each of the research topics that we have covered and we then present a viable way to go about utilizing the conclusions of the research, to help you become a sound investor.

Myopic Loss Aversion

The first research we wish to mention is on the **perception of loss**. How the human mind models loss and how people are impacted by losses more deeply than gains of the same value. We wish to discuss an attribute called Myopic Loss Aversion *(Richard H. Thaler, Amos Tversky, Daniel Kahneman, Alan Schwartz.1997)*

Myopic Loss Aversion (MLA) is explained by two factors:

A. Loss Aversion: People tend to be more sensitive to decreases in their wealth than to increases.
B. Mental Accounting: Mental accounting determines both the framing of decisions and the experience of the outcomes of these decisions.

The original paper has more details about the risk appetite of investors and how it is impacted by MLA. However, we summarize the two conclusions related to an investor's risk appetite in the aforementioned research by the following:

1. If, in an investment, all payoffs are increased enough to eliminate possible losses, investors will accept more risk.
2. An investor who monitors the investments in short intervals, appears to be more risk averse than an investor who monitors the investments relatively infrequently.

Asset Allocation and Information Overload

Another viewpoint on how the structure of information about investment options impacts our thinking is highlighted by a research on Information Overload. This research looks at the ways in which investment options are structured and how this affects investment decisions. (e.g. options in a defined contribution plan can confuse the investor). *(Julie R. Agnew and Lisa R. Szykman, 2005)*

A key observation mentioned in the research stated: "**Consumers tend to reduce the amount of effort they expend when decisions become more complex**". This tendency is highlighted in a study by Choi et al. [2004]. The authors found that 80% of participants in plans with automatic enrollment initially accepted the plan's low default savings rate and the conservative default investment fund. Three years later, over half these individuals maintained these 'default elections'.

The research concludes that the tendency mentioned above is mostly triggered by **Information Overload**. Information overload specifically refers to things that hamper a comprehensive evaluation of an option.

For example, it could be the small font size of the information displayed or the number of choices or complexity thereof. It becomes difficult for us to make certain difficult choices in the presence of a simpler, less complex but expensive, 'default option'.

In other research by Dan Ariely (covered in our past newsletter), it is shown that sometimes expensive choices are presented in a more attractive manner than other more rational ones, thereby misleading consumers.

Human beings have to make many decisions as part of daily life. Some of them are easy, some of them are difficult. The question that can be asked here is what really makes these choices easy or difficult? Well, we have pointed out some of the reasons, such as:

1. Large number of choices.
2. Complexity or less intelligible choices.
3. Presence of difficult choices along with simpler, less complex but expensive ones.
4. Presence of attractive but irrational choices along with unattractive but rational ones.

The above mentioned points are definitely factors at play, but research done by a professor Barry Schwartz, who teaches social theory at Swarthmore College, adds more dimensions related to the decision making process.

The Investor's Paradox

In *The Paradox of Choice*, Schwartz observes that people often choose the options that, in their opinion, will minimize the chance of experiencing regret in future. **Investors may be tempted to hold on to a losing investment** or recognize sunk cost as expenditure that is yet to occur, in an attempt to avoid acknowledging a misstep. *(Schwartz, Barry. The Paradox of Choice. New York: Harper Perennial, 2005.)*

Several studies cited in The Paradox of Choice have documented this bias involving sunk costs. Respondents in one study were given a hypothetical situation wherein they purchased nonrefundable lift tickets for two different ski resorts ($75), but later realized that both the tickets were valid only for one day. Thus they had to choose between Ski Resort 1 and Ski Resort 2. Ski Resort 1 costs $50, while the other costs $25. They were also told there is good reason to believe they would have a better experience on the $25 trip. However, the majority of respondents choose to go on the $50 trip because they had already paid the price of both tickets upfront. Thus, to offset their loss they choose to go with costlier ticket even though 25$ ticket would give them a better experience.

Schwartz, using the example of stocks, points out: "**what should matter in decisions about holding or selling stocks is only your assessment of future performance and not (tax considerations aside) the price at which the stocks were purchased**." Schwartz argues that sunk cost regret is greater when:

- A person bears responsibility for the initial decision.
- An individual can easily imagine or measure a better alternative.

Another challenge is the frequency with which we're exposed to new information that may represent an obstacle against maintaining a disciplined investment strategy. As we know from our earlier discussion about risk aversion, the less often people re-evaluate their decisions the greater their risk appetite and as per Schwartz, the less regret. However, with a barrage of new information, people get motivated to re-evaluate decisions more frequently.

Some of that information may arrive as part of experience of other investor(s). People tend to give more weight to anecdotal account of a single (or few) person(s) delivered to us directly, than to a survey of a large group of people read in a magazine or newspaper.

Another thing that people do with reference to their prior decisions is that, they tend to compare them with their past decisions or with decisions of other people. One valuable insight that Schwartz shares is that comparisons may lead to high expectations, and result in changing investments at the wrong time for the wrong reasons. So with all that information, how could you become a sound, mature and a smart investor? Well, worry not. We outline few important points and recommend some practices that would help you to become a better investor.

Our Advice

Well, we can summarize some of the practices that an investor ***should try*** to follow, such as:

- **Continuously striving to become more educated about investing.**
- **Understanding personal objectives related to investment.**
- Determining one's own risk appetite.
- Exploring all the practically possible and logically sound alternatives related to investments.
- Evaluating investment options carefully and comprehensively (without skipping the fine print).

We also recommend some things that an investor ***should try not*** **to engage in**. For example:

- **Evaluating decisions too frequently**.
- Comparing outcomes with past performance or outcomes of other people's decisions without an actual understanding of the real factors behind the outcome.
- Becoming sensitive to short term devaluation of investments.

Schwartz observes an important attribute associated with decision making. We quote Schwartz:

*"**We seem to do our best thinking when we're feeling good**. Complex decisions, involving multiple options… demand our best thinking. Yet those very decisions seem to induce in us emotional reactions that impair our ability to do just the kind of thinking that is necessary."* We would like our investors to focus on the first part. We need to feel good when we make important decisions. Not something easily controllable but it is always worth the attempt.

We conclude with a hope that our recommendations would assist you to gain a more pragmatic and cognizant approach to investing.

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