ALASKA HIGHWAY NEWS

Brad Brain: The pain of loss

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Brad Brain: "The pain of loss is real, and it is acute, and it lingers. And, importantly, it affects how you make money decisions. It's just one of the ways that emotional decision making can result in irrational decisions."
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Behavioral finance is the study of human behaviour. More often than not, people will make money decisions based on emotions, not on rational decision making. An example of this is how the pain of loss can hurt more than the pleasure of gain.

What got me thinking about this is I just experienced the pain of loss from an unexpected source recently, and it hurt. Right now I am supposed to be in Penticton with my kids. Each summer we go down for my son's hockey camp, and we turn it into a family vacation. But this year we had to come home early.

Don't worry, everything is fine, it's just one of those things. Nothing to do with COVID-19, or anything like that. It literally was just an unfortunate temporary setback.

But it sure did not feel that way.

As everyone has, I have missed out on a lot of stuff in 2020. I had conferences in Ottawa, Anaheim, Kananaskis, and Dubai booked. They are all gone, of course. I also had a number of fun things that I was supposed to do with my kids, and all that got cancelled too. That's just the way 2020 has gone.

And up until now, I have pretty much took all of this in stride. But I was really looking forward to this family time, and to have the carpet pulled out from underneath us, it didn't merely feel like an abbreviated vacation. It felt like a loss. And it hurt.

Now, this is not actually a sob story about poor Brad's horrible summer. The pain of loss has implications for how people will look at money decisions.

Let's say that we are going to play a game. In round one, you have $1,000 and have to pick from one of two options. Option one is a sure gain of $250. Option two is a 25% chance of doubling your money, but a 75% chance of gaining nothing. Which one will you pick?

Round two. This time you have $2,000, and you have to make another decision. Option one is a guaranteed loss of $750. Option two is a 25% chance to lose nothing, but a 75% chance of losing $1,000. Now which one do you pick?

Here's the catch: These are the actually the same outcomes, just expressed in different terms. On top of that, the expected mathematical outcomes are identical. But they don't feel the same, do they? That's the point of this exercise.

Studies show roughly five in six people will pick the guaranteed gain in round one, but only one in six will elect for the guaranteed loss in round two, preferring to take their chances risking an even larger loss in the hopes of avoiding loss altogether.

The pain of loss is real, and it is acute, and it lingers. And, importantly, it affects how you make money decisions. It's just one of the ways that emotional decision making can result in irrational decisions.

As Warren Buffett says, “To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

Many investors are still dealing with some type of emotional reaction to the extreme market volatility we saw a few months ago. The question is, are you making your money decisions based on a sound intellectual framework, or are emotions corroding that framework?

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