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# "The Art and Science of Loss Aversion"

By Tommy Williams, CFP®

Investing during the month of December was like crossing an icy mountain stream. It delivered a staggering shock to the senses that triggered the instinct to, "Get Out!" When it comes to investing, that instinct is called loss aversion. For many people avoiding a loss is more important than realizing a gain. Simply put, not losing $100 is more important than gaining $100.

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Erica Goode of The New York Times talked with psychologists Daniel Kahneman and Amos Tversky about a series of experiments they had conducted to measure loss aversion. The pair found relatively few people would bet money on a flip of a coin unless they stood to win at least twice as much as they might lose.

The desire to avoid losses is the reason many people sell stocks when the value of the stock market is declining. Unfortunately, it may be a poor choice for a variety of reasons. For example,

• Downturns are temporary. The Schwab Center for Financial Research evaluated the performance of the Standard & Poor's 500 Index since 1966 and found, *"the average bull ran for more than four years, delivering an average return of nearly 140 percent. The average bear market lasted a little longer than a year, delivering an average loss of 34.7 percent."*

While past performance is no guarantee of future results, understanding the history of gains and losses in bull and bear markets is critical because it can help investors avoid potentially costly mistakes.

• Markets rebound. Consider December 26. It was the best day for stocks in nearly a decade. The Dow Jones Industrial Average rose 1,000 points, posting its biggest daily gain in history.

Investors who were not invested in stocks missed an opportunity to participate in a market rebound. Despite significant gains late in the month, we just experienced the worst December performance since 1931, reported MarketWatch.

• Your long-term life and financial goals haven't changed. Sometimes, investors have to cross that icy stream, or muck across a muddy patch, as they move toward their goals. Your portfolio should be built to help you pursue specific life and financial goals. It may be well diversified to help minimize losses when you encounter challenging market conditions.

Consequently, if your long-term goals have not changed, selling during a downturn could make it more difficult to reach your goals.

However, if you're experiencing a high level of discomfort as the stock market fluctuates, it may be important for you to re-evaluate your risk tolerance and make any changes necessary to your asset allocation. The selection of the time to make those changes then becomes the crucial decision.

One of the most important aspects of our work as financial advisors has little to do with asset management or investment selection. It has everything to do with helping our clients make better financial decisions. We try to provide information and advice – coaching, if you will – that may help our clients avoid mistakes that may make it more difficult to achieve their goals. We also encourage clients to embrace choices which are likely to help them work toward their goals.

If you find yourself debating whether to hold your investments or sell them, please give us (or your advisor with whom you have an established trusted relationship) a call before you do anything. Your call should be welcomed so you might have the opportunity to talk about what's happening. Hopefully this will provide some realistic perspective which will set your mind at ease. If changes are necessary, meaningful options can be identified and the pros and cons of any alternatives can be intelligently weighed. Remember, the goal is to ensure that you are on track to meet established long-term objectives – not beat indices (S&P, Dow, Nasdaq, etc.). It also should not be to celebrate beating those indices. I might add, there is a lot to be said for a sense of feeling comfortable with your financial situation. Sleepless nights and a general feeling of financial vulnerability are not a path likely to maximize the quality of your human experience.

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