

Our “Risk” Wiring:

Human Tendencies To Gamble with Profits and Losses

By Jon M. Duncan, CFP®

Sound financial decisions simultaneously manage risk and return. Risk remains, however, the less understood step-brother/sister of return.

Concepts of interest and dividend income, growth and total return have become parts of our investment vocabulary. Basic definitions of risk, however, are not well understood by most investors. Investment geeks define risk using complicated-sounding statistical terms: standard deviation, correlation, and covariance.

Beyond understanding the concept of risk, is our behavior regarding risk. One of the reasons we humans have such a difficult time dealing with the concept of risk is related to the way we are “wired.”

In a landmark study conducted in 1979 two psychologists, Daniel Kahneman and Amos Tversky, discovered that people are often simultaneously attracted to both insurance (the avoidance of risk) and gambling (the seeking of risk). Moreover, they concluded that most people have an irrational tendency to be less willing to gamble with profits than with losses.

The explanation for our seemingly irrational behavior lies in the way we frame our decision choices. While it may be different for each individual, we all have an internal reference point or anchor from which we view or frame the future outcome of any financial decision. If, by adjusting our reference point, we frame the outcome as a potential gain, for example, then, other things equal, we are more inclined to make the decision than if we frame the outcome as a potential loss. As we gain more relative to our initial reference point, however, our inclination to continue to gamble decreases and our interest in preserving our gains increases.

If, on the other hand, we adjust our internal reference point such that the outcome of a decision is framed as a potential loss, then we are more inclined to avoid the risk, again holding other factors constant. But, unlike the case with gains, as we lose ground relative to our initial reference point, our inclination to continue to gamble *increases*. One academic writer refers to this tendency as “get-even-itis.” In Las Vegas it is called doubling-up to catch-up.

The implications of the Kahneman and Tversky study on individual financial decisions are significant and wide-ranging. It provides a theoretical framework for explaining how individual decisions are *actually* made as opposed to how they *should* be made under conditions of uncertainty. In practical terms, it explains why we:

- Hold-on to our money-losing investments too long;
- Take profits on our winners too quickly; and
- Over-insure

How we frame our financial decisions and, ultimately, the quality of those decisions, depends on how we define our internal reference point. The difficulty is that we tend to change our reference point based on our recent experience.

For example, in the mid- to late-1990's as the stock market soared some people adjusted their internal reference points higher, re-establishing the level from which future investment decision outcomes were framed. As a result, they never reached that point where the inclination to gamble decreased; they essentially started their psychological "value clock" over again. They remained risk-takers right up to the end when the technology stock bubble burst. Unfortunately, then they held-on to their losing stock positions for the same reasons.

The key to making sound financial decisions is to maintain perspective and not allow current market events (good or bad) to influence our internal reference point. Maintaining perspective, in turn, starts with a financial plan for achieving your long-term goals that is grounded in realistic expectations. By creating your plan, you will "anchor" your internal reference point to a return expectation that will serve as a reliable benchmark for managing risk.

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