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LOSS AVERSION

How Emotion Hurts Stock Returns

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As investors watched global stock markets tumble, the behavioral economist Richard Thaler, who is also an occasional contributor to The New York Times, offered the following advice: “Inhale, exhale. Repeat. Then watch ESPN.”

Wise words, even if they remain widely ignored.

Mr. Thaler’s advice flows from knowing that people are loss averse. It’s an insight he owes to the Nobel Prize-winning psychologist Daniel Kahneman, who has found that a loss yields roughly twice the psychological effect of an equivalent-size gain.

The problem is that if you look at the stock market each day, you’ll experience a whole lot of losses and feel a lot of pain. The heartburn that many investors are feeling this morning is an example of this loss aversion. The genius of Mr. Thaler’s advice is that if you tune into sports instead, you’ll avoid that pain. And it may lead you to make better financial decisions, too.

The numbers make the point. Over time, the stock market has risen enormously, but if you zoom in to the daily ups and downs, it’s easy to lose

sight of these long-run gains. Since the Standard & Poor's 500 index's creation in March 1957, it has fallen on 46.7 percent of all trading days. At the daily level, the stock market can seem like a roller coaster. Even though a purely financial calculation reveals that the gains more than make up for these losses, if you feel the losses twice as keenly as the gains, it's the sort of ride you might decide to avoid.

The perception that stocks offer too wild of a ride is one of the reasons that too few people invest in the market. In turn, stocks have to yield a higher rate of return than less volatile bonds in order to induce people to endure this heartburn.

But there's a way to avoid so much pain: Check your portfolio less often. When viewed over a longer horizon, the day-to-day fluctuations pale into the background, and the long-run upward trend in stocks comes into sharper focus.

If history is any guide, checking your portfolio weekly reduces the number of times you confront a loss, from 46.7 percent to 43.7 percent. Be more disciplined and check at the end of each month, and you realize losses only 40.4 percent of the time. And if you check your portfolio at the end of each year instead, you would have to deal with losses only 27.6 percent of the time.

Stocks offer a good bet over the long run. They have risen over every decade since 1900, with only two exceptions: the Depression-ravaged 1930s and the financial crisis-wracked first decade of this century. In both cases, those losses were relatively small, and were more than fully recovered before the next decade was out.

The point is that stocks aren't really that risky, at least if you're willing to ignore the noise and if you don't need to pull out the money in the short term. Inhale, exhale, repeat and watch ESPN. And next time someone asks you how your portfolio is doing, impress them with your knowledge of sports instead.

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