

Loss Avoidance: Potentially Harmful to Your Portfolio

This letter is about the tendency of many investors to avoid taking a loss on an investment that is not performing well. This phenomenon is linked to the psychological anomaly known as the “sunk cost fallacy”. We will begin with a story.

In the 1950s and 1960s, the British and French governments worked to develop a supersonic passenger airliner, called the *Concorde* – a commercial transport plane with the speed of a jet bomber. The Concorde would be capable of reaching speeds of over 1,300 mph, more than double the speed of the popular Boeing airliners.



The Concorde passenger plane

Yet the Concorde failed to be profitable. As development of the plane moved closer to completion, it became increasingly clear that manufacturing the planes would be a massive financial loss for the two governments. After sinking over £1 billion (roughly \$15 billion in 2014 U.S. dollars¹) in R&D and production, only 16 planes were ever sold, each at a loss².

Why did the British and French governments continue to pour taxpayer funds into the plane when it was clear that it would be unprofitable? It was because, in their minds, “they had invested too much to quit”. After pouring so much money into development, they found it unthinkable to give up and cut their losses, even when continuing on would have just made the losses even worse.

This is known as the *Concorde Effect*, or the *sunk cost fallacy*. The UK and French governments should have ignored the money they had already spent, and purely evaluated future costs versus future profits. Past costs (“sunk” costs) are largely irrelevant. But governments, corporations, and individuals often do the exact opposite. They take these sunk costs into account when making current decisions, which can lead to catastrophic results.

The sunk cost fallacy takes many forms.

A business owner spends thousands of dollars on the hiring of the new employee, but then finds out the employee is a net negative for the business. The business owner fails to fire the employee because of the money spent on training.

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You order a dessert. Even though you feel quite full and no longer want to eat it, you do so anyways because you have already paid for it (Thaler 1985).

You buy a stock at \$50. The stock falls to \$40. You look at the evidence and it tells you that selling is the best option. But because you have invested so much time and money into researching and buying the stock, you decide not to sell and continue to hold onto your shares.

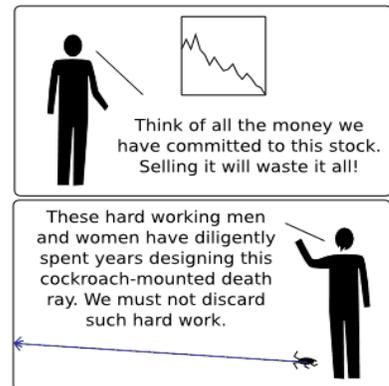
The sunk cost fallacy can have a disastrous impact for your investments. People often make decisions trying vainly to prevent wasting their earlier investment of time and money. They pin their *hopes* on a chance of breaking even at some point, even though the downside risk has increased beyond acceptable levels.

Imagine you have a stock down 20%. That 20% loss should be considered a *sunk cost*, a past expense that you can't change. Your decision on whether to buy or sell the stock shouldn't be affected by what you originally paid for it*.

Yet studies have shown just the opposite. Investors are much more reluctant to sell stocks that they would have to sell at a loss. This effect has been shown to be persistent and pervasive, with both individual and professional investors susceptible to it (Haigh and List 2005, Benartzi and Thaler 1995, Barberis and Huang 2001). Like the British and French governments wastefully poured money into an unprofitable airplane, investors will hold onto their losing stocks in *hope* that things will turn around, even when the current facts tell them to sell. In fact, investors are 50% more likely to sell a winner than a loser (Odean 1998).

The more time, money, anxiety, and mental fatigue investors expend on a stock, the more they become committed to it, and the less likely they are to sell the stock if it goes down. This is the same psychological principle that causes gambling addicts to get sucked into a game. After losing some money on a gamble, they try to recover it. The more money they lose and the more anxiety they incur, the more committed they become and the more they gamble, even when the rational part of their brains tells them to quit (Thaler 1990).

The sunk cost fallacy induces investors to hold onto their losers while selling their winners. But in most markets, the better strategy is the opposite, to minimize your losses and allow your winners to run. Over long periods of time, winning stocks generally tend to continue winning and losing stocks tend to keep losing, though this is not guaranteed and one can certainly find many exceptions (O'Shaughnessy 2005). But another reason it may be better to sell your losers than your winners is that our judgment on losing positions gets cloudy. Because of the sunk cost fallacy, it may become more difficult for us to make a rational, evidence-based decision.



Comic from thadguy.com

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Of course, that's not to say that selling your losers is a strategy cast in stone. Often, stocks that have declined bounce back, and these may even be good opportunities to buy more of the stock. But you need to avoid our innate, irrational bias to hold onto our losing positions. The money you've already lost is a sunk cost which should not factor into your decision. In your mind, pretend you don't even own the stock – if you would still choose to buy the stock, hold onto the position. Otherwise, you should consider selling it.

Please call me with any questions!

Derrick

**Ignoring tax implications and rebalancing for weight changes*

[1] <http://www.sjsu.edu/faculty/watkins/concorde.htm>.

[2] <http://www.concordesst.com/faq.html>. £1.065 billion in 1973 pounds translates to over \$15 billion in 2014 dollars, based on a 1.64 USD/GBP exchange rate in Sep 2014³ and a GBP inflation rate.

[3] <https://research.stlouisfed.org/fred2/data/EXUSUK.txt>.

[4] <http://www.ons.gov.uk/ons/datasets-and-tables/data-selector.html?cdid=CDKO&dataset=mm23&table-id=3.6>.

[5] Written by Chris Whatley with R.C. Whatley & Company

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