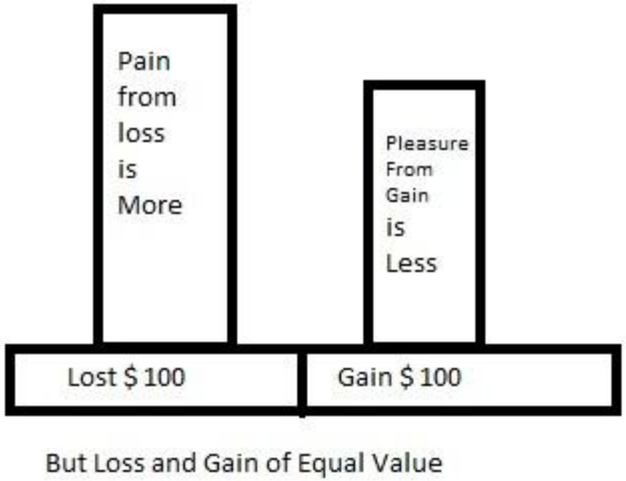
MYOPIC LOSS AVERSION

Why Myopic Loss Aversion Is Important To Understand For Long Term Investors

What is Loss Aversion

- People hate losses (and their Automatic Systems can get pretty emotional about them). Roughly speaking, losing something makes you twice as miserable as gaining the same thing makes you happy. In more technical language, people are “loss averse.”



Example

	You Win	You Lose
Head	$ X	
Tails		$ 100

- How much does X have to be for you to take the bet?

Example

- For most people, the answer to this question is somewhere around $200.
- This implies that the prospect of winning $200 just offsets the prospect of losing $100.

Another Example : Loss aversion: people hate to see their pay checks go down.

Myopic Loss Aversion

Myopic Loss Aversion and the equity premium Puzzle by Shlomo Benartzi & Richard H. Thaler

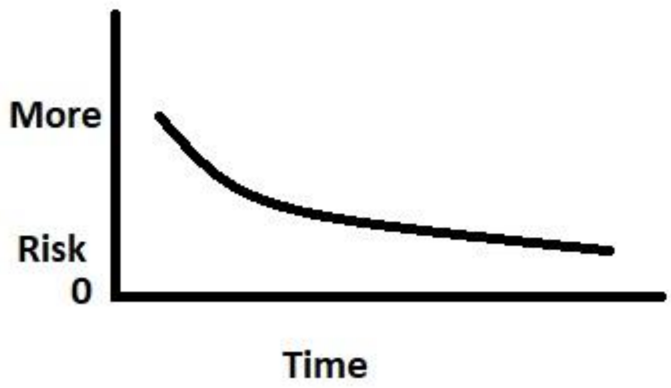
Prospect Theory

- Kahneman and Tversky's prospect theory'. The explanation has two components.
- First, investors are assumed to be 'loss averse meaning they are distinctly more sensitive to losses than to gains.
- Second, investors are assumed to evaluate their portfolios frequently, even if they have long-term investment goals such as saving for retirement or managing a pension plan. We dub this combination 'myopic loss aversion'.

Paul Samuelson (1963).

- *Samuelson asked a colleague whether he would be willing to accept the following bet: a 50% chance to win $200 and a 50% chance to lose $100.*
- *The colleague turned this bet down, but announced that he was happy to accept 100 such bets.*
- *This exchange provoked Samuelson into proving a theorem showing that his colleague was irrational Of more interest here is what the colleague offered as his rationale for turning down the bet:*
- *"I wont bet because I would feel the $100 loss more than the $200 gain.' This sentiment is the intuition behind the concept of loss aversion.*

Continue….



The attaractivness of Risky Assets

- **The attractiveness of the risky asset will depend on the time horizon of the investor.** The longer the investor intends to hold the asset, **the more attractive the risky asset will appear,**

Myopic Loss Aversion

- ***<u>Loss aversion.</u>*** We regret losses two- to two-and-a-half times more than similar-sized gains. Since stock price is generally the frame of reference, the *probability* of gain or loss is important. The longer the holding period, the higher the probability of a positive return.

- ***<u>Myopia.</u>*** The more frequently we evaluate our portfolios, the more likely we will see losses and hence suffer from loss aversion. Inversely, the less frequently investors evaluate their portfolios, the more likely they will see gains.

Example

Exhibit 6: Time, Returns, and Utilities

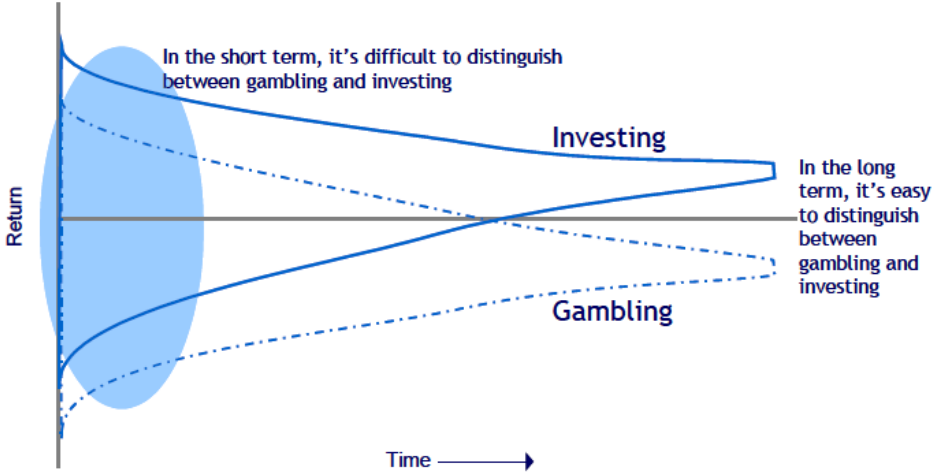
Time Horizon	Return	Standard Deviation	Positive Return Probability	Utility
One Hour	0.01%	0.48%	50.40%	-0.488
One Day	0.04	1.27	51.20	-0.464
One Week	0.18	2.84	53.19	-0.404
One Month	0.80	5.92	56.36	-0.309
One year	10.0	20.5	72.6	0.177
Ten years	159.0	64.8	99.9	0.997
100 years	1,377,961	205.0	100.0	1.000

Source: LMFM analysis.

- Exhibit 6 provides some numbers to illustrate these concepts. The basis for this analysis is an annual geometric return of 10% and a standard deviation of 20.5% (very close to the actual return and standard deviation from 1926-2003). The table assumes stock prices follow a random walk (and imperfect but workable assumption) and a loss aversion factor of 2.
- (Utility = Probability of a price increase − probability of a decline x 2.)
- Source : Decision-Making for Investors *Theory, Practice, and Pitfalls By Michael J. Mauboussin*

How we can Avoid Myopic Loss Aversion?

Exhibit 2: Investing and Gambling



Source: LMFM analysis.

Today's Investment community

- Average annual mutual fund portfolio turnover rocketed from from about 20% in the 1960s to over 110% today
- As well as investor mutual fund holding periods, which dropped from an average of roughly ten years in the early 1970s to roughly 2 ½ years now.
- The signatures of a quality long-term process include a focus on economic (versus accounting) value , low portfolio turnover, and relative portfolio concentration.
- An undue and incorrect focus on outcomes undermines the process.
- The best performers dwell on a process

Notes/Source

Notes/Source

1) Why Smart people make big money mistake and how to correct them
2) Nudge: Improving Decisions About Health, Wealth, and Happiness by Richard H. Thaler and Cass R. Sunstein
3) MYOPIC LOSS AVERSION AND THE EQUITY PREMIUM PUZZLE By Shiomo Benartzi Richard H. Thaler
4) Decision-Making for Investors *Theory, Practice, and Pitfalls By Michael J. Mauboussin*

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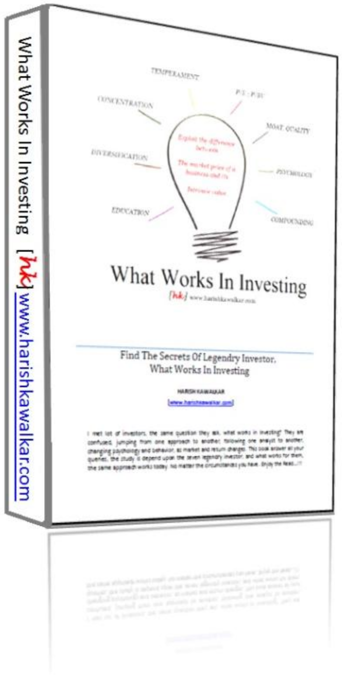

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Which is an Investment company. The company main focus involved in investing in long-term investments such as equity shares and equity-related securities. The original inspiration for launching Kawalkar Investment Consultancy Private Limited was to set up value investment firm in India, and develop a well educated investor in India.

You can read my blog at www.harishkawalkar.com