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Fear itself

Chris Dillow

Investors might be missing out on thousands of pounds of returns because they own too few equities, according to new research. This, says Christoph Merkle at the University of Mannheim, is because they are overestimating the pain of losses and so taking too little risk.

He asked over 2,000 retail investor clients of Barclays how happy they were with the returns on their equity holdings. He found that when they were asked about prospective returns, investors who anticipated gains were much happier than those who expected losses. Nothing at all surprising there. However, when they were asked about actual recent returns, the differences in happiness between winners and losers were much smaller. People who had done well reported less happiness than expected, while people who had suffered losses were less unhappy than expected. "People are better at coping with losses than they think they'll be," says Professor Merkle.

One reason for this might simply be that, quite often, high prices mean lower subsequent returns while low prices should mean higher expected returns. To this extent, investors who have lost might comfort themselves with the thought that their portfolio might bounce back, while successful investors might fret that the good times won't last.

But, says Professor Merkle, something else might be at work. We have, he says, a "projection bias"; we overestimate the extent to which our future tastes will resemble our present ones and so we underestimate the extent to which we'll adapt to good or bad times.

However, we know that people do in fact adapt even to extremes of good or bad fortune. One US study in 1978 found that big lottery winners weren't much happier than average while people who'd been paralysed in accidents weren't as unhappy as might have been expected. More recently, Andrew Clark at the Paris School of Economics has found that happinessadaptation to major life events such as marriage or widowhood "appears to be rapid and complete".

All this could mean that some of us might be under-investing in equities because we are overestimating how bad we'll feel if we lose money - perhaps because we're exaggerating the pain of having to delay retirement and work longer. However, this is only true for those of us who have an accurate assessment of the probabilities of those losses. It could be that for some investors the projection bias is offset by wishful thinking and/or overconfidence, with the result that they are holding the right amount of equities. Sometimes, cognitive biases cancel each other out.

If, however, your assessment of likely returns is accurate - that is, if you think there's around a one-third chance of a real loss over a 12-month period insofar as the past is any guide to the future - then the projection bias might be causing you to under-invest in equities.

For decades, shares have (on average!) done better than economic theory predicts; this is the famous equity premium puzzle, one implication of which is that people own too few shares. Perhaps projection bias, and the underestimation of losses, is one reason why.

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