Chris Dillow December 13, 2018

What we have to fear

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What do investors have to be scared about? You might think the answer's obvious: losing money. In fact, it's not as simple as that.

Research by Christoph Merkle at Kuehne Logistics University shows why. Before the 2008 crisis he asked hundreds of UK clients of Barclays how they would feel if they were to see big falls in their equity portfolios. Obviously, they replied that they'd be unhappy. But here's the thing. When he surveyed them a few weeks later, when they had actually seen such losses, he found that they were much less upset than they anticipated. Losses don't hurt us as much as we fear.

A big reason for this, believes Professor Merkle, lies in what Harvard University's Matthew Rabin calls projection bias: we project our current tastes into the future and so fail to see that these will change, that we'll adapt to bad fortune. (This isn't just true of financial losses: Andrew Clark at the Paris School of Economics has shown that it's also true of other traumatic events such as divorce.)

How do we adapt? One way is that when the market falls we can comfort ourselves with the thought that everybody else is in the same boat. The cliché's right; a trouble shared is a trouble halved. And we can blame bankers and politicians rather than ourselves.

There's something else. For many of us, income and wealth are positional goods: we care not just about their absolute level but how we compare to others. "What matters to someone who lives in a rich country is his or her relative income," Warwick University's Andrew Oswald has said. Sara Solnick and David Hemenway, two US economists, have established this. Back in February 1995 they asked Harvard University students whether they'd prefer an income of $50,000 a year when everybody else had $25,000 a year or $100,000 a year when everybody else got $200,000. Most preferred the $50,000.

A fall in equities generally leaves our wealth and future incomes intact relative to other investors. For many, this is a comfort.

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But it has an important implication. If widespread losses don't hurt us but falling behind others does, then what hurts us are losses that are specific to ourselves – ones that result from our decisions to deviate from the average portfolio.

The pain such losses cause isn't just (or even I suspect mainly) a drop in relative wealth. It's also because we suffer a blow to our ego. If we lose money on a stock we've carefully researched and where we think we know something the market doesn't, we question our judgment: this is one reason why people hang onto losing stocks – they hate admitting they were wrong. It's one thing to be poorer; it's another to think ourselves stupid.

And then there's regret. If we lose money on a tracker fund we won't regret it much, simply because a tracker fund is the default investment. But if we lose on an obscure Aim stock, we do.

It's not just what we do that we regret, however. Sometimes, we regret what we don't do: we can kick ourselves for not buying a share such as Amazon or Apple when it was much cheaper. This is one reason why there are sometimes bubbles in assets, such as we've seen in Bitcoin: the fear of missing out causes investors to pile into assets because others are doing so.

All this might help explain an otherwise strange fact – that, often, there is no trade-off between risk and return. Aim stocks, or high-beta stocks, for example, seem riskier than others but they have not on average delivered high returns to compensate. This puzzle disappears if the risk that really matters to us is that of relative loss. By definition, these losses are idiosyncratic and cancel out across investors: for everybody who's underweight in a stock, another is overweight. As Eric Falkenstein at Pine River Capital Management has said, if risks are idiosyncratic they cannot be priced and so there will be no risk-return trade-off.

There is, however, a nice counterpart to this. It means that equities in general have offered us something like a free lunch. We've been overcompensated for taking on market risk in the past because generalised stock market losses don't hurt us as much as we expect them to. This deepens the equity premium puzzle. But, for me, it is yet another argument for preferring tracker funds.