Losses – Can You Take Them?

The subject of selling losing investments seems to be very relevant in volatile market conditions. This can only be described as one of the most difficult of markets to manage as an investor. When markets are rising consistently investing is easy. It should be just as easy when markets are falling consistently, but it isn't for most novice investors, who find it difficult to act on their stop loss levels. However, when markets go generally sideways with significant up and down swings, even quite experienced investors come under real pressure to follow their investment plan and to act on stop loss levels faultlessly.

Successful investors have learned that one of the keys to high returns is to let profits build and to cut losses quickly. They are ruthless in quickly selling investments that fail to unfold as they expected. On the other hand, if an investment begins to pan out as they thought that it would, they will prudently build on their initial position and show great patience in allowing the investment the time needed to meet their expectations.

This is diametrically opposed to what most novice investors do quite naturally. It is far more common to see tyro investors losing money because they do the exact opposite. If an investment they make begins to show good results, they usually snatch small profits quickly and miss out on even bigger gains. This is bad enough in terms of the opportunity missed, but when things go wrong beginners are most likely to freeze and to be unable to cut their losses, which grow ever larger as they ride the stock downwards.

This is one of the many ways in which the best investors have learned to think in opposite ways to the natural instincts that we all start out with as we begin the journey from novice to mastery as investors. It is a big subject, which we will return to many times in subsequent articles in this series.

For now we will focus on one of the most important aspects in which the best investors excel over the novices: dealing with investments that go off the rails. Warren Buffet famously said *Rule No 1: Never lose money. Rule No 2: Never forget Rule No 1*. This is how important the great investor believes it is to avoid loses.

The irony that escapes many beginners, though, is that the counterintuitive way to avoid losses is to accept them. If we take the loss from a bad investment while the loss is still small, it can't go on to become a much larger loss.

The reasons why most people find it difficult make the decision to cut a losing investment are complex. Possibly the most interesting one is what Richard Thaler described in 1980, as the ***sunk cost fallacy***. It is one of the more important reasons why investors ride losses rather than making a more rational decision.

Sunk cost is a well-established idea from economics. It is a cost that has been incurred, but which is largely not recoverable. Where the sunk cost fallacy comes in is when the largely unrecoverable cost is used mentally to drive an irrational decision. At some time we will have all seen the sunk cost fallacy in action without realising it.

James and Dianne bought their house ten years ago for $450,000. Since then their family of four children has outgrown the house and they need more bedrooms. James has also changed his job and now lives a long way from where he works. The time lost and expense earned in travelling to and

from work has started to get him down. He would dearly like to move closer to his work, which would also favour Dianne, who would be closer to employment as she re-joins the workforce. They put the house on the market, but after many months, the best offer they receive is $410,000. Their real estate agent argues this is the market rate. Even though Dianne wants to accept the offer and move on, James is adamant that he will not let them have their house for $410,000 when he paid $450,000 for it. He digs his heels in on that point alone and they take the house off the market. They commission an extension to the house and James and Dianne are doomed to expensive, long and tiring journeys to and from work for many years.

The way to see past the sunk cost fallacy is this: Money that has already been paid is a sunk cost. It relates to the past. It has gone and the transaction cannot be magically reversed. The rational way to deal with such a situation is to assess the options that are now possible. For James and Dianne the two most obvious options were to either: take the price at which the market was now valuing their house and move to a new suburb near James' work, or to stay put, extend the house and suffer the cost and inconvenience of travelling. Clearly, the first was the better option, demonstrated by their desire to put the house on the market so they could move. What blocked the rational decision was when James became stuck on the original cost of their house; the sunk cost that was not a relevant consideration, because it related to a different market at a different time.

In investing, the original price paid for a share is a sunk cost. If the share falls in price over time, there is no certainty that the sunk cost can ever be recovered. The sunk cost fallacy comes in when an investor is reluctant to make a rational decision to take a loss on the share because "the current price is less than I paid!"

Most of us will have heard this reasoning and even used it ourselves in the context of investing, or about various other aspects of life. It comes up almost any time people have a choice of continuing on a bad course or cutting their losses by changing course.

To avoid the sunk cost fallacy as investors, it is necessary for us to change the way we think about the situation. We have to internalise that nothing we do today or tomorrow, no decision we make now or in the future, will ever change something that has happened. The only thing we can do is to affect what happens from now on. We can never change the past, but we can affect the future.

What we paid for a stock is a sunk cost. It is gone. What we now have is a tranche of stock which is worth what we can sell it for. It is seductive to imagine that if we just sit out the loss, the price may go back to what we paid and we can then sell and get out even. This is the most common and utterly natural way most people think. It is the sunk cost fallacy writ large.
Yes, it is possible that the price may rise again in the future. It is equally possible that the price might continue to fall. In fact, a chartist will tell you that if the stock is in a downtrend, it is more likely to continue to fall than to rise, because trends tend to persist.

The solution lies in changing the way we think about losing investments. We have to list the options open to us, which are:

1. Hold on, hope and pray.

2. Sell and switch into a better investment opportunity.

3. Sell and sit in cash awaiting a better investment opportunity if there is not one available at the moment.

Options two and three are the rational decisions. Option one is the sunk cost fallacy in action.

Another, albeit extreme, way to grasp this point is: Suppose that I held a gun to an investor's head and gave her a choice to sell the loss-making investment or be shot. She would now see only two options and make the rational choice. What I would have done here is to have forced the investor to put out of her mind the sunk cost, which is what she paid for the losing investment.

If I now invited the investor to make a choice between buying that same stock back or buying some other stock, she would most probably now make the rational decision to consider all of the alternatives, free of the sunk cost fallacy.

The rational investor should work at developing a habit of forgetting the sunk cost and focusing at all times on the full range of alternatives open: to continue, to switch or to liquidate.

Perhaps we should give Warren Buffett the last word: *The most important thing to do when you find yourself in a hole is to stop digging.* Richard Thaler would add: *and start to consider all the alternative ways out of your predicament.*

A loss never bothers me after I take it. I forget it. But being wrong - not taking the loss - that is what does damage to the pocketbook and to the soul. Jesse Livermore

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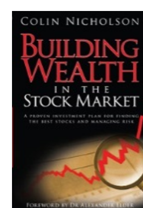

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