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YOUR MONEY | THE SKETCH GUY

# Overcoming an Aversion to Loss

By **CARL RICHARDS** DEC. 9, 2013

We've all heard (probably too much) about the downfall of Lance Armstrong. If you've followed his career at all, you know how committed this guy was to winning. Last week, I happened to see the trailer for the documentary "The Armstrong Lie." It opens with a close-up shot of Armstrong's chiseled face staring intently into the camera and explaining what drives him:

"I like to win, but more than anything, I can't stand this idea of losing. Because to me, losing means death."

It played out that way. Armstrong decided that avoiding the pain of losing was worth any cost. Now, it seems as if it could very well cost him everything.

Turns out that most of us don't like losing. In fact, it's what the academics call loss aversion. We feel the pain of loss more acutely than we feel the pleasure of gain. In other words, we may like to win, but we *hate* to lose.

The psychologists Daniel Kahneman and Amos Tversky showed that even something as simple as a coin toss demonstrates our aversion to loss. In a recent interviews, Mr. Kahneman shared the usual response he gets to his offer of a coin toss:

"In my classes, I say: 'I'm going to toss a coin, and if it's tails, you lose \$10. How much would you have to gain on winning in order for this gamble to be acceptable to you?'

“People want more than \$20 before it is acceptable. And now I’ve been doing the same thing with executives or very rich people, asking about tossing a coin and losing \$10,000 if it’s tails. And they want \$20,000 before they’ll take the gamble.”

In other words, we’re willing to leave a lot of money on the table to avoid the possibility of losing.

We see this aversion to loss play out in the lives of real people when we try to make smart money decisions, especially when it’s time to make a change to our investments. It almost doesn’t matter what change we need to make. We hesitate to change from the current situation because it means having an opinion and making a decision. And with a decision comes the very real possibility that we’ll make the wrong one. Sticking with the status quo feels much better even if we know it’s costing us money.

Just think of the things you won’t do even though you know you should. For example, let’s imagine that a few years ago, you invested in the process of planning and built a financial plan based on your values and goals. Now you have a portfolio of low-cost, diversified investments, but you’re still holding on to a stock your brother-in-law recommended years before that went down right after you bought it. It clearly doesn’t fit in your plan. Every rational thought, every spreadsheet and every calculator tells you that it’s past time to get rid of it, but you don’t.

Making the choice to sell would mean realizing a loss, and I’m not just talking from a tax perspective. To some degree, it means admitting we’ve made a mistake, but we’d feel the loss, too. As we’ve discussed, we’re wired to go to great lengths to avoid that feeling. Once we realize that loss and open ourselves up to the pain of that experience, we’ll discover that we feel almost twice the emotion over a loss as opposed to a gain.

To get past our aversion to loss, I recommend taking the Overnight Test. It’s something I’ve discussed previously, but it’s an excellent tool that helps us separate the emotion from a decision. Let’s go back to the earlier example. You have a low-cost, diversified portfolio, and you have the stock your brother-in-law recommended. Now, let’s play a little game.

Imagine you went to bed, and overnight someone sold the stock and replaced it with cash. The next morning, you have a choice: You can buy back the brother-in-law's recommended stock for the same price, or you can take that cash and add it to your well-designed portfolio. What would you do?

Most people wouldn't buy the stock back.

Just by changing your perspective (investing cash versus getting rid of the stock), you can gain clarity and have the emotional space to make the decision you know you need to make. Sometimes, that's all it takes. While we'll probably never embrace loss, it's good to know that we can find ways to work around our aversion to it when it makes sense.

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