

RATIONAL INVESTING IN IRRATIONAL TIMES.

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Mistake 9: Do you avoid admitting your investment mistakes? (Regret Avoidance)

How many times have you said to yourself, or heard others say, “I will sell it when it gets back to what I paid for it”?

Avoiding the facts, however, doesn't change them. Regret avoidance leads to two investment mistakes. The first mistake is that an asset should be held only if it makes sense to do so in the overall context of the portfolio's asset allocation. What you paid for the security should have no bearing (except for the tax consideration) on whether you should continue to hold it. The right question to ask is: If I did not own any amount of a particular stock, would I buy any at the current price to fit into my portfolio plan? If the answer is no, then you should sell it, because every day you continue to own the security at current prices you are effectively making a decision to buy it.

There is a second mistake that regret avoidance causes. Whenever you have an asset in a taxable account with a significant unrealized loss, you should sell the asset to realize the loss for tax purposes. It is even more important to do so if the loss is short term, as the tax deduction obtained with the loss will be at the higher ordinary income tax rate, rather than the lower long-term capital gains rate. By “harvesting” the loss you will be able to use the loss to offset other gains in the portfolio, thereby reducing your tax bill.

If the asset with an unrealized loss still fits within the overall strategic asset allocation of the portfolio, one of two options should be considered when selling the stock or mutual fund. The first option is to simply sell and repurchase the same security after thirty days. This allows you to avoid the “wash sale” rule, which states that repurchasing the same or a substantially similar security within thirty days causes the two trades to be considered a wash, rendering the loss non-deductible. This strategy does run the risk that the stock/fund might rise substantially during the thirty-day waiting period. On the other hand, the stock/fund might fall substantially. The other strategy is to swap the asset for a similar, but not substantially identical, security. For example, if you own an S&P 500 Index fund with a loss, you might sell it and simultaneously buy a Russell 1000 fund. The two funds should perform very similarly. Another example might be that if you owned Merck, you might sell it and buy another pharmaceutical company such as Pfizer. After another thirty-one days have passed, if you desire, you can reverse the swap and once again hold your original asset.

You can prevent the paralysis induced by regret avoidance by remembering that tax-managing a portfolio is a very important part of the investment process. While we all would like to only have winners in our portfolio, realizing losses to obtain the tax benefit is part of the winning strategy. Once the loss is realized, you are less likely to make the mistake of buying the same security again if it no longer fits into your overall portfolio plan. If the losing asset is not in a taxable account, then the sell decision should be made as part of a regular portfolio review. Remember to ask yourself whether or not the asset still fits within the over- all plan and if you would buy it today if you didn't currently own it.

There is one other mistake that is related to regret avoidance, one that relates to load mutual funds. First, there is no reason to purchase mutual funds that carry loads when there are perfectly good low-cost, no-load alternatives. There is no evidence that load funds outperform no-load funds. The load itself is just another hurdle the fund has to overcome in order to outperform its benchmark. Investors who already own load funds are reluctant to sell them because selling the fund would force them to admit that they made a mistake in paying the load in the first place. They feel that the load fee would be wasted if they sold the fund. Unfortunately, the load has already been paid; it is what

Mistake 10: Do You Let The Price Paid Affect Your Decision To Continue To Hold An Asset? (Endowment Effect)

Put yourself in the following situation: You are a wine connoisseur. You decide to purchase a few cases of a new release at \$10 per bottle, and you store the wine in your cellar to age. Ten years later the dealer from whom you purchased the wine informs you that the wine is now selling for \$200 per bottle. You have a decision to make. Do you buy more, sell your stock, or drink it?

Faced with this type of decision, very few people would sell the wine-but very few would buy more. Given the appreciation in the wine's value, many might choose to save it to drink on special occasions. But the decision not to sell, while not buying more, is not completely rational. The wine owner is being influenced by what is known as the "endowment effect." The fact that the wine is something you already own (an endowment) should not have any impact on your decision. If you would not buy more at a given price, you should be willing to sell at that price. Since you wouldn't buy any of the wine if you didn't already own any, the wine represents a poor value to you and thus should be sold.

The endowment effect causes individuals to make poor investment decisions. It causes investors to hold on to assets that they would not purchase if they didn't already own any, either because they don't fit into the asset allocation plan, or they are viewed as so highly priced that they are poor investments from a risk/reward perspective. The most common example of the endowment effect is that people are very reluctant to sell stocks or mutual funds that were inherited, or were purchased by a deceased spouse. I have heard people say, "I can't sell that stock, it was my grandfather's favorite and he'd owned it since 1952." Or, "That stock has been in my family for generations." Or, "My husband worked for that company for forty years, I couldn't possibly sell it." Another example of an investor subject to the endowment effect is stock that has been accumulated through stock options or some type of profit-sharing/retirement plan.

Financial assets are like the bottles of wine. If you wouldn't buy them at the market price, you should sell them. Stocks and mutual funds are not people-they have no memory, they don't know who bought them, and they won't hate you if you sell them. An investment should be owned only if it fits into your current overall asset allocation plan. Its ownership should be viewed in that context.

You can avoid the endowment effect by asking this question: If I didn't already own the asset, how much would I buy today as part of my overall investment plan? If the answer is, "I wouldn't buy any," or, "I would buy less than I currently hold," then you should develop a disposition plan. There is one further consideration to be given to disposing of an "endowment asset": There may be substantial capital gains taxes involved. If this is so, you might consider donating the stock to your favorite charity. By donating the financial asset in place of cash you would have donated anyway, you can avoid paying the capital gains tax.

MISTAKE 13: Do You Believe You Are Playing with the House's Money? (Mental Accounting)

In their wonderful book *Why Smart People Make Big Money Mistakes*, Gary Belsky, a writer at Money magazine from 1991 to 1998, and Thomas Gilovich, a psychology professor at Cornell University, relate the following legendary tale. By the third day of their honeymoon in Las Vegas, the newlyweds had lost their \$1,000 gambling allowance. That night in bed, the groom noticed a glowing object on the dresser. He realized it was a five-dollar chip he had saved as a souvenir. The number seventeen was on the chip's face. Taking this as an omen, he donned his green bathrobe, rushed down to the roulette tables, and placed the five-dollar chip on the square marked seventeen. Sure enough, the ball hit seventeen. The thirty-five to one bet paid \$175. He let his winnings ride, and once again the little ball landed on seventeen, paying \$6,125. And so it went, until the lucky groom was about to wager \$7.5 million. Unfortunately, the floor manager intervened, claiming that the casino didn't have the money to pay should seventeen hit again. Still clad in his bathrobe, the young man taxied to a better-financed casino. Once again he bet it all on seventeen, only to lose it all when the ball fell on eighteen. Broke and dejected, the groom walked back to his hotel room. "Where were you?" asked his bride. "Playing roulette." "How did you do?" "Not bad. I lost five dollars."

The "Legend of the Man in the Green Bathrobe" illustrates what behavioral finance people call "mental accounting," the tendency to value some dollars less than others, and thus to waste them. In the case of the man in the green bathrobe, mental accounting allowed him to think of the \$7.5 million he lost as the "house's money," not his. Investors make this same mistake. Let me explain.

A good friend had been either lucky or smart enough to buy Cisco at 5. The stock represented a relatively small portion of his net worth. When the stock reached 80, this was no longer the case. The sharp rise in the price of the stock had caused his position in Cisco to become a substantial portion of his portfolio. When I asked if he would buy any at the current price, he said, no. I then stated that if he wouldn't buy any, he must believe that it was either too highly valued or he was currently holding too much of the stock and it was too risky to have that many of his eggs in one basket. Despite the logic of my argument, he steadfastly refused to sell some shares for the following reason: His cost was only five, and the stock would have to drop about ninety-five percent before he would have a loss. I then asked him if he owned a green bathrobe.

A few months later Cisco had hit thirteen and he was still holding it. Now this man is one of the smartest people I know. He also had studied and was a big fan of the work of Amos Tversky and Daniel Kahneman, among the founding fathers of the field of behavioral finance. Yet mental accounting had caused him to make the same mistake as the man in the green bathrobe. He had considered his unrealized gain as the "house's money," instead of his own. Just as the man in the green bathrobe could have taken his chips and cashed them in, my friend could have sold the stock at 80 and converted his unrealized gain into nice green cash.