Emotions Series:
Regret

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Editor’s note: This is the fourth in a series of articles about emotions and the lessons they hold for investment advisors and their clients.

Your client’s target asset allocation is 60 percent equities and 40 percent bonds, but now that the stock market has zoomed, the actual allocation to equities has increased to 70 percent and the actual allocation to bonds has decreased to 30 percent. Would you rebalance the portfolio to its target allocations or leave it alone?

Choices about portfolio rebalancing are a crucial part of the practice of financial advisors. These choices never are easy because they have both monetary consequences and emotional ones. Your client’s wallet would be fatter if stocks tumble soon after you rebalance by selling some of them. But it would be thinner if stocks continue to zoom. Moreover, you’ll feel the emotion of pride if your client’s wallet is fatter, but you’ll feel the emotion of regret if your client’s wallet is thinner.

Kahneman and Tversky (1982) described regret as the pain we feel when we easily can imagine a different choice that would have led to a better outcome. There is a close link between the emotion of regret and the cognitive biases of mental accounting and hindsight. And there is a close link between regret and the responsibility for choice.

To understand the links, imagine that you fractured a leg in a car accident, lost consciousness, and were taken by an ambulance to a hospital. Your leg healed, but not very well because the doctors at that hospital were not very competent. You surely feel the physical pain in your leg, but do you feel the extra emotional pain of regret?

You had a choice whether to make the trip that day or not and you carry responsibility for that choice. Mental accounting bias leads you to frame this particular trip in a mental account distinct from the mental accounts of all other trips you have made without incident. Hindsight bias leads you to believe that you could have seen in foresight that the road would be congested that day, chosen not to drive, and avoided the accident. Now you regret the choice to drive that day. But you had no choice of the hospital you were taken to after the accident because you were unconscious at the time. So you bear no responsibility for the choice of hospital and suffer no additional regret that would have come if you’d had a choice of hospitals and chosen the one employing incompetent doctors.

We can see the effects of aversion to regret in many financial contexts, including the “disposition effect.” Shefrin and I (1985) coined this term to describe the reluctance of investors to realize losses and attributed it to cognitive biases, namely mental accounting and hindsight, and the emotion of regret. The price of a 20-year Treasury bond purchased for $1,000 a year ago might have declined to $900 because interest rates increased during the year. Normal investors frame a bond into a mental account, distinct from mental accounts that contain their other assets. This bond mental account now registers a $100 paper loss relative to the purchase price. Normal investors are fooled by hindsight into believing that they could have seen in foresight that the value of the bond was about to decline. They feel the pain of regret when they observe the $100 paper loss and that pain only intensifies when they realize the loss because realization exiguishes all hope of recovery.

Rational investors always prefer more wealth to less and never are confused by the form of wealth. Normal investors do not conform to that definition. Normal investors distinguish paper losses from realized losses that are different only in form, and they are willing to sacrifice wealth as they forego the tax benefits of realized losses. Yet many studies, including those of Shefrin and myself (1985) and Odean (1998) demonstrate that the reluctance to realize losses is common.

We can also see the effect of aversion to regret in the quest for “mental liquidity,” a term coined by Fisher and myself (2007). Assets are economically liquid when they can be sold quickly with no loss relative to their fair market value. Assets are “mentally liquid” when they offer investors options to obscure losses relative to reference prices and options to avoid their realization. The price of the Treasury bond purchased for $1,000 a year ago declined to $900. That
bond is almost perfectly economically liquid; investors can sell it for $900 less a small commission. But the mental liquidity of the bond is impaired if investors are unable to avoid the observation of paper losses relative to the purchase price or if they feel compelled to postpone the sale of the bond so as to avoid the regret that comes with the realization of losses. Still, the bond is more mentally liquid than a stock because bondholders have the option to wait until the maturity date and avoid the realization of losses while stockholders do not have that option.

We observe the importance of aversion to regret in commentary about the advantage of ladders of individual bonds over bond mutual funds. Individual bonds have greater mental liquidity than bond mutual funds because bondholders have the option to wait until the maturity of each bond, receive the bond’s face value, and avoid the pain of regret that comes with the realization of losses. Bond mutual fund holders have no such option because bond mutual funds have no maturity date and the marking-to-market of net asset value implies that investors never are assured that they can avoid the realization of losses, no matter how long they wait.

I experienced my own aversion to regret last year when I reviewed my portfolio and decided to rebalance it by increasing the allocation to a particular group of stocks. But I did not rebalance it all in one day. Instead, I arranged to rebalance my portfolio by switching in equal increments on the 12th of each month during the following eight months.

The rational professor of finance in me frowned on this arrangement, but the normal investor in me chuckled. I, like all normal people, want to avoid the pain of regret. Switching gradually in a sequence we know as dollar cost averaging is designed to avoid the pain of regret.

I had a choice to switch in one lump sum or switch in small increments during the following eight months. I was responsible for the choice and I easily could imagine that the stocks I was switching into in one lump sum would take a tumble the day after I switched. I could anticipate the pain of regret I would feel and wanted to avoid it. Dollar cost averaging helped me do that. When I switch only a portion of my stocks I feel regret if they decline soon after, but not as much as I would feel if I were to switch the entire amount.

Financial advisors know well the pitfalls of regret in the attempts of clients to avoid it by shifting responsibility. There is some laughter and much bitterness in the old saying among stockbrokers: “When the stock goes up the customer says I bought the stock. When it goes down the customer says my broker sold me the stock.” Brokers and financial advisors are tempted to strike back, shifting responsibility and the pain of regret to clients. A cartoon shows a financial advisor saying to a client: “If we’re being honest, it was your decision to follow my recommendation that cost you money.”

Decisions to rebalance portfolios are wise but they are difficult because rebalancing has a greater potential for imposing regret than leaving things alone. Aversion to regret instills in advisors the unwise inclination to refrain from rebalancing portfolios, but advisors can overcome that inclination by making rebalancing a routine part of their practices. Routine serves as an effective defense against regret because routine reduces responsibility. In turn, reductions in responsibility yield reductions in the potential for regret and the need of clients and advisors to play the blame game.

REFERENCES


