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Sunk Costs and Loss Aversion

Published on: 6 October, 2023 | Author: Investment Team

The Sunk cost fallacy occurs when we have invested a lot of time, money, energy, or indeed love, in something and we persist in it even though it is a lost cause. The investment itself becomes the reason to carry on when it would be much better to simply wrap-up, accept we made a wrong turning, and move on.

As a business author recently put it, “if you’ve ever held on to a pair of shoes that make your feet ache or a pair of pants that no longer fit for no other reason than you paid a lot of money for them, you’ve experienced sunk-cost bias.”

The phenomenon is closely associated with “Loss aversion.” It seems human beings are much more sensitive to avoiding loss than to the pleasure of an equivalent gain. Experimental evidence suggests that we are twice as sensitive to losing than gaining.

Decades of experience have taught us that investors are very sensitive to portfolio declines and that sense of loss is exacerbated when it leads to a decline in the value of the original capital invested. That rawness reduces when losses eat into previous gains but over time, we all raise the base value of our investments such that losses always remain painful.

The fact remains that losses are a part of any investor’s life cycle and that occasionally, we simply must recognise that what we thought would happen, hasn’t, and therefore the value of a specific investment is less valuable, in perpetuity, than we thought.

If we allow them, “Sunk cost”, would say hold on and its cousin, “Loss aversion”, would prevent us disposing of the asset and putting the funds elsewhere to more productive use.

One of the lessons of markets is that while they generally move higher over time, individual firms and individual securities do not always recover from loss. Having lost so much money in them, even the doyen of investing Mr Buffett has long bemoaned his attitude to airline stocks suggesting that investors would have done better “to shoot the Wright brothers before they ever became airborne.”

What can we do therefore to mitigate the strong cognitive biases that militate against positive decision-making?

One option is to remove the possibility of making a wrong decision at all but that’s harder than it seems.

A senior City practitioner once remarked to us that “Every economic crisis is really a banking crisis.” We find it hard to imagine a time before banks were safe but until the advent of deposit insurance, developed after the depression years of the 1930s, they really were not.

Even after the introduction of deposit insurance, the queues enveloping Northern Rock a few years ago was eloquent testimony to the heft of loss aversion. The very recent failures of Credit Suisse in Europe along with First Republic, Signature Bank and Silicon Valley Bank in the US are a further reminder that deposit security and managerial competence are two sides of the same coin and can’t always be guaranteed even by government writ.

The risk-free option for developed world investors is government debt. Always put something in your portfolio that can only increase in value. In the UK we are lucky to have National Savings, essentially the retail arm of the UK Treasury and its counterpart, the Gilt-edged Market.

Even here caveats apply; Argentinian government debt is self-evidently not a safe place to invest but Italian, Spanish, and Greek citizens have seen the benefit of anchoring their debts to the rock of the Bundesbank and then the ECB.

Government debts: Gilts, German Bunds, French OATS, Spanish Tesoros and Italian BTPS along with US Treasuries are all guaranteed by governments and underwritten by their respective taxpayers. Some of them, the UK Index-linkers for example, even guarantee the real value of capital investment (if bought at issue) over very extended time frames.

The only requirement for successful investment in these markets and the avoidance of the Sunk Cost and Loss Aversion problem, is good governance, as the Argentina example exemplifies.

If we stuck only to government bonds however, we would have missed the industrial revolution, the IT revolution, and perhaps the coming AI revolution. As always, portfolio diversification and a keen understanding of your time horizon is key to successful investment. In the long run, the best guarantor of wealth is to own your part of the productive capacity of the economy whilst recognising that in the long run we are all …, well, you know the quote.