MOI GLOBAL

Prospect Theory and Loss Aversion

This article is part of a multi-part series on human misjudgment by Phil Ordway, managing principal of Anabatic Investment Partners.

Prospect theory and loss aversion have a lot to say here. And beyond the idea of losing something owned or almost owned, there is a related deprival factor. Scarcity – real or perceived – is a huge driver of human behavior.

The **QVC countdown clock** is a great example of induced scarcity that drives behavior. We all know that if something is really going to sell, it's just a matter of patience in waiting to get more supply. But when people see the QVC countdown clock, or when they see lines wrapped around the **Apple store for a new iPhone release**, the sense of scarcity takes over the decision-making process.

Another example of deprival super-reaction syndrome could come from the **pension crisis**. America's pensions are underfunded by trillions and many are already running into extreme trouble. The police and fireman's pension in Dallas, Texas is already facing severe issues, that's in Dallas, not some low-growth or sclerotic economy. Millions and millions of people think they have pensions, but what will happen in the mathematically inevitable case that requires benefits to be cut and/or taxes to be raised? America's social fabric could be in for a real test by this threatened removal of something almost possessed but never actually possessed.

The **hangover from GFC** has influenced an entire generation of investors. How many bad decisions were made in 2007-08-09-10 or since, all because of deprival super-reaction syndrome? How many people were scared into liquidating their last assets, right near the bottom? (See Bannon example below.) How many were scared out of coming back into the market when assets were cheap but the psychology was scary? How many people – or institutions – have had a new or outsized focus on short exposure to protect from that double-dip recession or crisis 2.0 that was always right around the corner?

How much of the interest in **short-selling** in general derives from deprival super-reaction syndrome? Shorting is a fascinating intellectual exercise that is occasionally very profitable. I saw it firsthand when I started my first job as a very green analyst in April 2007 and was assigned to cover financials. After an immaterial false start on the long side, I quickly got religion and shorted everything I could find in 2007 and 2008. And then that success landed us a short-only SMA for a few years…starting in 2009. Even before that I was never really convinced that this was a good activity for long-term investors who are only looking to protect principal. If done well – a big if – it can protect short-term downside volatility, sure, but I think that's it – the main benefit is in subverting the deprival super-reaction syndrome effects in individuals and in institutional allocators. If you're looking at any meaningful period of time – i.e., anything more than a year or two or anything not cherry-picked to look good for short sellers – the base rate for short selling is terrible. It is a tough, tough way to accomplish most goals in investing.

Other examples of deprival super-reaction syndrome include **airline fares and "ancillary revenues,"** also known as the fees the airlines charge for bags, food, etc. The fact is that airfares are down ~25-50% in real dollars over the past few decades, but they are down less or flat in nominal terms. And during that time fees on checked luggage and early boarding

became the norm, and the food isn't "free" in coach anymore, and in some cases the legroom is more pinched, all of which leaves some passengers to believe they're getting a raw deal. But all the nostalgic talk of the "good old days" of airline travel is just that – nostalgic drivel fueled by deprival super-reaction syndrome and contrast phenomena. Customer behavior will tell you that the majority of customers fly on price and that all other factors rank a distant second in the decision-making process. The number of people who can afford to fly has skyrocketed, and all the economic activity and personal gain generated by more choice in travel is enormous but hard to measure. And even though some airlines have recently segmented their cabins or reduced legroom on some seats, that has always been the tug-of-war in the price-or-value experiment that all airlines experience.

And legroom isn't even down much compared to 30 years ago! Even if it were, customers in coach now have a climate-controlled, quiet jet aircraft offering myriad travel choices and little perks like wifi connectivity, seatback entertainment systems, etc. Even first- and business-class seats are cheaper in real dollars than they were decades ago, and now they have luxury lie-flat accommodations with exceptional connectivity and entertainment options. And let's not mention – vivid counterexamples notwithstanding – that modern air travel is the safest mode of transportation the world has ever seen. There are twice as many planes in the air today as there were 25 years ago, but the accident rate has made steady downward progress. The International Civil Aviation Organization reports that the fatal accident rate is one-sixth what is was in 1980.[46] The same applies to terrorism, by the way – we all remember the tragedy of 9/11, but the 1960s/70s/80s were beset by horrific bombings and hijackings that are exceptionally rare today.

On balance, customers are getting a better deal and a better experience than ever before, but high-profile customer problems and the recent diatribes in the media – accusing the airlines of answering only to their financial masters on Wall Street or being uncaring monsters in general – would have you believe that things have never been worse.[47]

Another potential example in this regard with a different twist is the pervasive effect of **inflation** over time. Do investors notice the erosion of their purchasing power? Everyone loves to complain about how "things are more expensive these days," but how many decisions actually get made with the explicit thought that a dollar today is likely to have 10%, 25%, or even 50% less purchasing power within the next few years/decades? Have central banks adopted this framework as a lesser of two evils?

[46] https://www.nytimes.com/2017/05/27/opinion/sunday/there-was-no-golden-age-of-air-travel.html
[47] https://www.nytimes.com/2017/05/28/business/corporate-profit-margins-airlines.html