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Behavioral Finance Insights for Wealth Managers and Their Clients

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Blackjack, Regret Aversion and Your Wealth

If you are like most people, you have a list of actions you should take, but you often get paralyzed by the fear of taking the wrong path. Such inaction often results in leaving money on the table. This article explores the root cause of such behavior and its ramifications for personal finance.

Before considering particular aspects of personal finance, let us start with a simple game like blackjack. For those unfamiliar with the rules of the game, you play against a dealer. The dealer gives you two cards facing up. Suppose you received a nine and a seven, so your total is 16.

Turning back to our example, should you take another card or not? You already have 16 points. If you receive an ace, two, three, four or five, you get closer to 21, which increases your chances of winning. However, if the new card is a six or higher, you automatically lose because your total will exceed 21.

The dealer also receives two cards. However, you can only see one of the cards. Suppose the dealer has a seven, but you do not know what the second card is, since it is faced down.

To win the game, your cards need to total more than the dealer's cards. You can increase the total value of your cards by simply asking the dealer for additional cards, one at time. However, if your total exceeds 21, you bust and immediately lose.

Before you decide whether to take another card or stand pat, let's consider how the dealer is going to play. Once you make your decision (if you don't bust), the dealer's other card is flipped over. If the total does not exceed 16, the dealer has to keep taking more cards until the total exceeds 16. These rules must be followed (individual choice is not allowed for the dealer!).

Have you decided whether to take a card or wait it out? Most people stand pat, keep their hand viable, and let nature take its course. Is that the right choice?

Seminal research by Baldwin et al (1956) outlined the optimal strategy more than 50 years ago. When you have 16 and the dealer has 7, you should take another card. This strategy is often referred to as the "basic strategy" and is available on the web as well as in pocket-size paper guides.

People often act not so much to maximize their wealth, but to minimize their regret when bad things happen.

Comparison

Paul invests in AMR. During the past year he considered switching to Google, but decided against it. He now finds out that he would have been better off by $10,000 if he had switched to Google.

George invested in Google. During the past year he switched to AMR. He now finds that he would have been better off by $10,000 if he had kept his Google shares.

Who feels greater regret?

Yet, most people persist in being too conservative, failing to take a card when it is optimal to do so (see research by Carlin and Robinson 2008). This is all the more striking when you consider that they are being too conservative, even though they are willing to expose themselves to such risks in the first place.

Why do we observe this behavior? The primary reason is that people experience more regret from actions they have taken than from inaction. Consider the following illustration of this behavioral principle, based on the influential work of Kahneman and Tversky (1982):

Note that Paul has forgone $10,000 due to his inaction, whereas George lost $10,000 due to his action. If you are like 92 percent of the population, you believe George feels greater regret.

The asymmetric role of regret in actions we take versus inaction can also explain why many blackjack players stop at 16 instead of drawing another card. The regret associated with drawing another card, exceeding 21 points and losing the game, is far greater than the regret associated with losing by standing pat.

Lack of action often debilitates individual investors and undermines their finances. Identifying such cases and discussing them with a financial advisor can get you on a path to capturing all of the wealth and happiness that you have earned.

To give you a better sense of the types of actions individual investors often avoid due to fear of regret, consider the following two examples. First, suppose you maintain a large cash account for years, because you are reticent to jump into the market. Often this occurs because people anticipate how badly they would feel if the market were to drop right after they entered. In comparison, if the market did rise and you did not jump in, you would be disappointed, but not as much as if you had taken an action that went wrong.

It is never too early or too late to evaluate your financial plans. Don't let inaction guide your financial future.

Unfortunately, identifying the "perfect" time to enter the market is almost impossible. And, investing all your money in cash accounts is a dubious long-term strategy. Now is the time to discuss with a financial advisor what actions you should be taking to achieve your goals.

Consider a second example in which you own several stocks in a portfolio, and one stock does so well that the portfolio becomes undiversified. That is, the fraction of your wealth in that one stock has gone up from say 10 percent to 50, or even 80 percent.

In most cases, the recommended move is to sell some of the stock that has been performing well and rebalance the portfolio. Being introspective, are you inclined to do this? Many investors are not. Why? Because they anticipate the regret they would feel if the price of that stock rose following its sale. Again, now is the time to evaluate your portfolio with your advisor.

To summarize, many circumstances require action, and fear of regret may be responsible for both inaction and underperformance. Recognizing cases in which you might fall into this trap is the key to capturing all the fruits of your labor. Don't leave anything on the table: discuss your next move with a financial advisor.

References

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