Chapter 9

"Get-Evenitis": Riding Losers Too Long

People appear to be predisposed to "get-evenitis." Are they?

Get-evenitis refers to the difficulty people experience in making peace with their losses. I first discussed get-evenitis in chapter 3, when I introduced the concept of loss aversion. Meir Statman and I (Shefrin and Statman 1985) coined the term *disposition effect*, as shorthand for the *predisposition toward get-evenitis*. In this chapter, I describe the extent to which the disposition effect permeates the investment landscape.

This chapter discusses the following:

- instances of loss aversion in equity markets, mutual fund management, and real estate
- the documentation of loss aversion in the general financial literature

Case Study 1: Cy Lewis

Get-evenitis afflicts both sophisticated and unsophisticated investors. In this first case, I present a sophisticated investor.

Alan "Ace" Greenberg, currently Bear Stearns Company's chairman, believes that "the definition of a good trader is a guy who takes losses."[1] This view almost prevented him from rising to the head of Bear Stearns. His predecessor, Salim "Cy" Lewis, was known for his resistance to take a loss, holding on to every stock he bought.[2] The two clashed. At one point in the 1960s, Mr. Greenberg was able to convince Mr. Lewis to permit him to take losses, but only by threatening to

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resign. "Before then, he wouldn't let me sell," Mr. Greenberg recalls. "From then on, he let me sell anything I wanted to."

Case Study 2: Investors in Steadman Mutual Funds

Next, consider investors who are not quite as sophisticated as Cy Lewis. Some of the most insightful and entertaining examples of loss aversion have involved holders of Steadman mutual funds. According to quarterly ranking data from Lipper Analytical Services, between June 30, 1994, and April 15, 1997, at least one of the four Steadman funds has had the worst ten-year returns.

Through the 1950s, 1960s, and early 1970s, Melvin Klahr, a math instructor at Broward Community College in Pembroke Pines, Florida, invested about $1,000 in Steadman American Industry and a predecessor fund. In June 1997 his position was worth about $434. His last Steadman purchase was at the end of 1974. Had he placed $1,000 in the average capital-appreciation fund at that time, his position would have appreciated to $29,000 today. But Klahr stubbornly continues to hold onto his Steadman shares. Why has he not been able to bring himself to sell them?

Mr. Klahr says: "'Cause I'm so stupid. . . . Every time I think about selling it, I think, oh, I think it's going up a bit more." To be sure, the Steadman funds do have their moments. In January 1997, Steadman American Industry and Steadman Associated were up 13.6 percent and 14.7 percent, respectively. This placed them in the top four of diversified stock funds for the month.

In spite of this kind of occasional performance, Klahr does not see his resistance to selling his Steadman position as rational. "Maybe I don't need a financial planner so much as I need a psychiatrist," he says.

Loss Aversion: The General Phenomenon

Although psychiatric intervention might be a bit of an extreme, the aversion to selling at a loss definitely has very strong psychological roots. In chapter 3, I indicated that the phenomenon of get-evenitis is central to prospect theory, the framework developed by Daniel Kahneman and Amos Tversky (1979). Investors who behave in accordance with prospect theory do not mark their assets to market, at least internally. Rather they keep track of their trades in terms of gains or losses relative to the price they originally paid.

Think back to Cy Lewis and Melvin Klahr. Both exhibit loss aversion. Mentally, neither marks to market. Both are eager to get even before they will close out a position. Both suffer from get-evenitis.

Case Study 3: Charles Steadman's Strategy

Get-evenitis leads people to take chances in order to avoid taking a loss. I have already discussed Steadman shareholder Melvin Klahr. But let's also look at Charles Steadman, the late manager of the Steadman funds. He too experienced losses, and his path to those losses is intriguing.

William Steadman, Charles's older brother, started Steadman funds in the 1950s. According to the *Wall Street Journal*, when William died in the 1960s, Charles took over and acquired the right to manage several other mutual funds. Some did well, and assets in all of the Steadman funds together reached $160 million.

A few years ago, the performance of the funds deteriorated, but not abysmally. But then Steadman became ensnared in a legal issue with state securities regulators and the Securities and Exchange Commission. Although the SEC lost a lawsuit against Steadman, it has for the most part blocked the majority of Steadman funds from selling new shares to the public. New inflows did not offset redemptions; thus, as a proportion of money managed, expenses soared. In a January 1997 regulatory filing, two of the funds reported expenses of 25 percent of assets a year, compared to an average of 1 to 2 percent for most stock funds.

How did Mr. Steadman react? To try and earn more than his huge expenses, Mr. Steadman used leveraged, risky investments. On Dec. 31, 1996, Steadman Associates had 16.7 percent of its portfolio invested in Intel Corp. warrants. These warrants gave an investor the right to buy Intel stock at a fixed price. Because it is a leveraged instrument—like a call option—the return to a warrant tends to be quite volatile. If Intel were to close below the exercise price when the warrant expired, then the warrant would expire worthless.

In an April 1997 article, Robert McGough of the *Wall Street Journal* reported that Mr. Steadman came into 1997 with high hopes. In January, Charles Steadman wrote to shareholders that the "performance in 1997 should be reasonably good, and the fund will continue to participate in stocks of high-quality companies. . . . [U]pward movement of stock prices is strongly correlated to the extensive transformation of the national economy from technological discovery and accompanying

increased output that we have experienced in recent years, a phenomenon which I disclosed to you a year ago."[3]

Case Study 4: Investing to Fund College Education

Real-world events have a lot of texture, more so than the simple questions involving prizes and probabilities that I discussed in chapter 3. This next case offers a considerable amount of detail to help you understand the context, range of emotions, and unpredictability associated with real-world decisions.

Reality looks much more obvious in hindsight than in foresight. People who experience hindsight bias misapply current hindsight to past foresight. They perceive events that occurred to have been more predictable before the fact than was actually the case. As we study case 4, which involved a real estate investment, I will ask you a series of questions to mitigate the effect of hindsight bias. Some of the questions pertain directly to hindsight bias.

Bill and his wife are in their early thirties and have just had their first child. A good friend of theirs named James has been actively investing in real estate for the last several years. James has displayed a knack for finding undeveloped property that looks like a mess but has great potential. After purchasing a property, James's formula has been to clean it up, divide it into parcels, and resell it at a substantial profit (without adding any structures to the land). In the last three years, James has been able to resell most of his properties for between one and two times what he paid for them. Since his initial purchases were made with borrowed funds, a common practice in real estate investment, James has been earning an extremely high rate of return.

Several years ago James had encountered some personal problems, and Bill was very helpful and supportive during that time. Since then, James has always tried to repay Bill for his kindness in whatever way he could. Last year James recommended that Bill join James by investing in a small rural tract, which Bill did. This year James had been able to sell the tract for 75 percent more than their initial investment. Bill and his wife bumped into James one evening, and James was quite enthusiastic about another deal, predicting: "You'll want to go in with us on this."

With the birth of their child, Bill and his wife have begun to think about setting aside more money for the future, particularly in respect to funding their child's college education. They know that even when the returns on an investment look attractive, those returns can turn out to

be quite modest once inflation and taxes are taken into account. They are wondering whether the deal mentioned by James might be a suitable investment for funding their child's future college education.

Later when they meet with James, he tells them the details. A development company that has just declared bankruptcy purchased Clear Lake Development and is eager to sell. James believes that the property has great potential for retirees. It lies in a rural area, on the shore of a lovely lake.

The price tag for Clear Lake would be $205,000, and James suggests that they go in jointly, as equal partners. That is, James would invest $102,500, and so would Bill and his wife. James plans to follow his usual formula. After subdivision, he would sell all the lots within a year or so, for a total of $459,000. Bill and his wife currently have $17,500 in savings, and James assures them that he can arrange for them to borrow the remaining $85,000 at an attractive interest rate. James says that he is a great believer in leverage because it can offset inflation and taxes that really eat into initial returns.

1. On a scale of 1 to 10, how would you rank Clear Lake as an investment whose purpose is to fund college education in fifteen years? Here 10 means *extremely suitable* and 1 means *entirely unsuitable.*

During the first few months, Bill has been making payments on his $85,000 loan. In addition, he is no longer earning a return on the $17,500 of his own money that he invested. When he sees James a few months later, Bill asks him how Clear Lake is doing. James replies that a small glitch has come up.

Apparently, the property had never been surveyed properly, and he has now commissioned a survey. However, no lots can be sold until the survey is complete, and the survey is taking more time than he anticipated. Moreover, the original $85,000 loan has come due and must be renewed. Renewal is not a problem, but the bank only wants to renew the loan for $75,000. Consequently, Bill will have to come up with the additional $10,000 himself. James is clearly embarrassed, but he also remains upbeat about the ultimate success of the project. Fortunately, Bill and his wife have been able to save exactly $10,000 in recent months, and so have the necessary funds.

2. If you were in Bill's situation at this point, how would you react emotionally? Would you be *worried?* or *anxious?* Or would you be patient, believing that most investments incur some glitches here and there and that you are better off having minor problems than

major ones? How might you feel, if you found yourself in this situation: worried, anxious, or patient?

3. If you were Bill or his wife, would you begin to experience any feelings of regret? Specifically, would you feel that anyone should be blamed?
4. If you answered yes, whom would you blame most: yourself, James, or the situation?
5. Think about how the scenario has unfolded so far. At the outset, how obvious does it seem to you that it would have gone this way? That is, were any telltale indications present? How would you answer this question on a scale of 1 to 10, where 10 is *very obvious*, and 1 is *impossible to predict?*

Time passes. In fact, a full year has passed since Bill made his initial investment in Clear Lake. In a conversation, James apologizes that it has taken a year for things to get moving, but says that they now are on the move. He realizes that this has been a period of negative cash flow for Bill, but James says he can work things out so that Bill and his wife won't have to make any more payments on their loan. He, James, will handle the financing details. Moreover, to speed up sales, he will put up a model home on one of the lots. However, he thinks he can take care of the associated costs without asking Bill to contribute additional funds.

The next time Bill sees James, James tells Bill that he has good news and bad news. The good news is that the model home has been built and sold. The bad news is that the sale has not stimulated additional interest in Clear Lake. James says that he feels just terrible that he brought Bill into this venture, and is concerned that it will turn into a cash drain for Bill before too long. Therefore, he proposes taking over Bill's interest in Clear Lake, including all further interest payments, and asks Bill if he would like to sign his interest over to James. If Bill does so, he basically pulls out of this investment. In the event of a further cash drain, Bill would avoid the *extra loss*. But if the investment turns profitable, Bill *loses out on the chance to lower his loss, recover his investment, or make a positive return.*

6. Put yourself in Bill's shoes. How would you react to James's proposal? You are aware that James is more knowledgeable about the real estate market than you are, but you don't think that he would take advantage of you. He is too good a friend. However, you have

now invested $27,500 in Clear Lake. If you sign over your interest to him, you will have to come to terms with a $27,500 loss. If you keep your interest, you risk losing more money. But by keeping your interest you might also recoup your investment if lot sales pick up. What would you do at this stage?

a. Tell James you understand that he is trying to help you and come to terms with a loss by signing your interest over to him.

b. Remind James that he said that this was going to pay for your child's college education, and you still expect it to do that (in other words, you want to keep your interest).

7. Imagine that *six* years have passed from the time Bill made his initial investment. As in question 6, James proposes that you sign your interest over to him. In this connection, James also tells you that one of the real estate agents selling Clear Lake lots has offered to purchase all the remaining unsold lots for $35,000. Together with the $8,900 received from the sale of the lot with the model home, the total amount received for *all* the lots would amount to $43,900. Imagine that James informed you that he had decided to accept the real estate agent's offer, and then offered you the opportunity to sign your interest over to him. As in question 6, this offer includes James's taking full responsibility for all future interest payments associated with the loans that were taken out to enter the deal. Would this additional information change your answer to question 6? What would you do in this case?

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Typically, people who have read the case about Bill and his wife do not think that Clear Lake is a particularly good investment for funding a child's college education. However, once committed financially, they become very reluctant to pull out. When problems begin to develop, they become a little anxious. The majority begins to experience feelings of regret and blame themselves. When James proposes taking over their interest, very few accept his offer in the circumstances I described in question 6. A few more accept the circumstances described

in question 7. However, many do not. They cannot *come to terms with the loss.*

This is a real-world case. So how did it actually turn out? In the end, the real estate investment that went sour did not prevent Bill and his wife from sending their child to college. Chelsea Clinton entered Stanford in 1997 as part of the Class of 2001. By now, you may have recognized the major players in this case: Bill and his wife are President Clinton and Hillary Rodham Clinton. Clear Lake is Whitewater, and James is the late Jim McDougal. Note that the dollar sums I described are quite close to the actual amounts.

James Stewart, in his 1996 book *Blood Sport*, reports that Jim McDougal did offer, on more than one occasion, to take over then-governor Clinton's interest in Whitewater. He also reports that the Clintons declined those offers. In what seems to have been a strong case of get-evenitis, Hillary Rodham Clinton is quoted as saying to Susan McDougal, Jim McDougal's wife: "Jim told me that this was going to pay for college for Chelsea. I still expect it to do that!" (p. 133)

It appears that President and Mrs. Clinton suffered from a particularly bad case of get-evenitis. Their failed Whitewater investment eventually became the responsibility of Vincent Foster, a White House aide who committed suicide. The subsequent uproar led the White House chief counsel at the time, Bernard Nussbaum, to explain to President Clinton that he had a choice: Either take his financial records from Whitewater and appear before a Congressional panel, which would involve a personal and political cost to be borne immediately; or take his chances with the appointment of an independent counsel who would most likely cast an extremely wide investigative net.

As we all know, President Clinton took his chances with an independent counsel, and eventually ended up having Kenneth Starr investigate his Whitewater deal and much more. In early 1998, a scandal erupted involving a sexual relationship between the president and a White House intern, Monica Lewinsky. At the time, the president was defending himself in a suit filed by a woman named Paula Jones, who had accused him of harassment during his term as Arkansas governor.

While being deposed in the Paula Jones lawsuit, President Clinton was asked, under oath, if he had had a sexual relationship with Ms. Lewinsky. As we all know by now, he had in fact been involved with Ms. Lewinsky. At the time of the deposition, he faced a choice. He could take an immediate loss (embarrassment at the minimum) or deny the affair and take the gamble that he would not be caught. Being loss averse, he took the gamble.

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When the media broke the story of the affair, the president faced a choice: Admit publicly at once to the relationship; or deny involvement and take his chances.

Is there some kind of pattern here? Being loss averse, Clinton denied his involvement, wagging his finger at the television cameras and proclaiming: "I want you to listen to me. . . . I did not have sexual relations with that woman, Miss Lewinsky."

Several months later, he faced Kenneth Starr in a grand jury proceeding and under oath admitted to an inappropriate relationship. By this time, the political establishment was hoping and expecting that the president would address the nation and apologize for deceiving them during the preceding seven months. President Clinton had two courses of action: Address the nation and apologize for his behavior, thereby taking an immediate loss; or admit to some measure of responsibility but make no apology, and instead attempt to refocus the debate by attacking the independent counsel. Even if you did not know how these events eventually turned out, how would you bet at this stage?

As we are aware, the case eventually moved to the floor of Congress, and in December 1998, the House passed two articles of impeachment, one for perjury and the other for obstruction of justice. William Jefferson Clinton thus became only the second president ever to be impeached by the House of Representatives. In 1999 the Senate tried President Clinton and acquitted him on both charges.

In April 1999 the judge in the Paula Jones case cited President Clinton for civil contempt, because he lied under oath. As this book goes to press there are media reports that Kenneth Starr is preparing to indict the president at some point. So the case may not be over. But whatever the eventual outcome, the lesson is clear.

Plenty of Company

Our list of people who suffer from loss aversion now includes the former head of Bear Stearns, a long-time investor in mutual funds, the manager of a group of mutual funds, and President and Mrs. Clinton. Earlier in the book we saw how loss aversion led to the collapse of Barings Bank, and prevented the executives of Apple Computer from terminating the Newton project in a timely fashion (see chapter 3). Later in the book, we shall encounter instances that are more dramatic. However, the evidence about the prevalence of loss aversion among investors goes beyond anecdote and laboratory experiments.

Meir Statman and I (Shefrin and Statman 1985) suggest that people generally sell their winners too early and hold their losers too long. Realizing a loss is painful, despite the possibility of a tax advantage. An investor who recognizes the tax benefit but finds the psychological cost too painful experiences a self-control problem. Some investors find ways to realize tax losses eventually, notably, by using December as a deadline.

Recent work by Terrance Odean confirms that this is so. Odean (1998a) reports his findings on the disposition effect based on a study of approximately 163,000 customer accounts at a nationwide discount brokerage house.

For each trading day and individual account, Odean looked at the value of all the stock positions that corresponded to capital gains. Some of these gains would have been realized on that day, and others would not. Odean compared the fraction of all gains sold on this particular day with the fraction of losses realized.

Investors who are loss averse realize more of their paper gains than they do their paper losses. It turns out that from January through December, investors realize gains 1.68 times more frequently than they realize losses. This means that a stock that is up in value is almost 70 percent more likely to be sold than a stock that is down. Only in the month of December do investors realize losses more rapidly than gains, though only by 2 percent.

Which stocks do investors trade the most frequently? They trade stocks that have outperformed the market in the two years prior to the transaction. But although investors tend to realize their smaller losses, they continue to hold on to their larger losses. Perhaps investors act like Melvin Klahr, waiting for their paper loss to disappear. One of the big surprises in Odean's study is that investors sell the wrong stocks. They receive subpar returns from the losers they keep. But the losers they sell subsequently do great.

In a similar vein, Jeffrey Heisler (1994) provides empirical evidence about the impact of loss aversion on futures traders. His data consist of over 2,000 individual futures account–trading histories, containing more than 19,000 trades, covering the period November 1989 through October 1992. The study deals with the behavior of off-floor traders in the Treasury Bond futures market of the Chicago Board of Trade. Heisler found that off-floor traders hold initial paper losses longer than trades that show initial paper gains. Significantly, he finds that when traders hold losers, their trading activity is nonprofitable. Only

24 percent of the accounts in his sample show a profit over the period he studied. On average, off-floor traders lose $17 per contract traded.

Finally, remember the third case, concerning Steadman's strategy? The example may be an outlier, but Steadman's approach is typical for mutual fund managers. Keith Brown, Van Harlow, and Laura Starks (1996) report that fund managers who find themselves in the middle of their comparison group by midyear subsequently increase the risk of their fund's portfolio during the second half of the year. For further details see chapter 12, on open-ended mutual funds.

Summary

Most people exhibit loss aversion: They have great difficulty coming to terms with losses. Consequently, people are predisposed to hold their losers too long, and correspondingly sell their winners too early. I provided several examples of the phenomenon in this chapter. However, there are others to be encountered elsewhere in this volume. Some pertain to money managers. Other examples pertain to decisions by corporate executives who, reluctant to terminate losing projects, instead throw good money after bad.