

Cut and run: New research predicts risk avoidance in the face of chronic economic loss

October 27 2008

Individual investors are liquidating their holdings at record levels as financial markets sink, often absorbing losses to avoid possibly worse pain later. Contradicting the counsel of many financial advisers, it also flies in the face of widely accepted behavioral theory and reinforces recent research by Michigan State University scientists.

In short: People suffering lengthy periods of economic loss tend to swallow their losses, cash out and hunker down. Nobel Prize-winning "prospect theory," meanwhile, predicts that people will be more likely to gamble to recoup their losses.

"Our results challenge prospect theory," said Joe Arvai, associate director of the MSU Environmental Science and Policy Program. "As people are pulling money out of their retirement accounts and choosing the relatively safe, risk-averse option of putting it in a bank, they're validating our results."

Arvai is a member of the MSU Cognitive Science Program. In research he published last December with Louie Rivers, an MSU assistant professor who studies decision making and risk, people were given money to play a simple game. It was set up so people repeatedly lost money. Prospect theory predicts that players would gamble to recover their losses so after the game ended, players were given an opportunity to enter a lottery in which they could win back their money.

"What we found was that people didn't like gambling in this context," Arvai said. "They were very averse to risk and preferred to take a sure loss over a big gamble to get their lost money back."

"In today's economic situation, leaving money in a 401(k) account is a gamble, the higher-risk option," Rivers explained. "The safer but costly approach is to pull the money out and that's what many people seem to be doing."

Record redemptions from equity mutual funds and flight from bond funds have been recorded the past two months, while cash is being stashed in what one financial analyst called "mattress-equivalent savings vehicles" by worried investors.

For more information on MSU risk and decision research, visit www.msu.edu/~sknkwrks/index.html .

Source: Michigan State University

Citation: Cut and run: New research predicts risk avoidance in the face of chronic economic loss (2008, October 27) retrieved 20 April 2024 from <https://phys.org/news/2008-10-chronic-economic-loss.html>

This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.