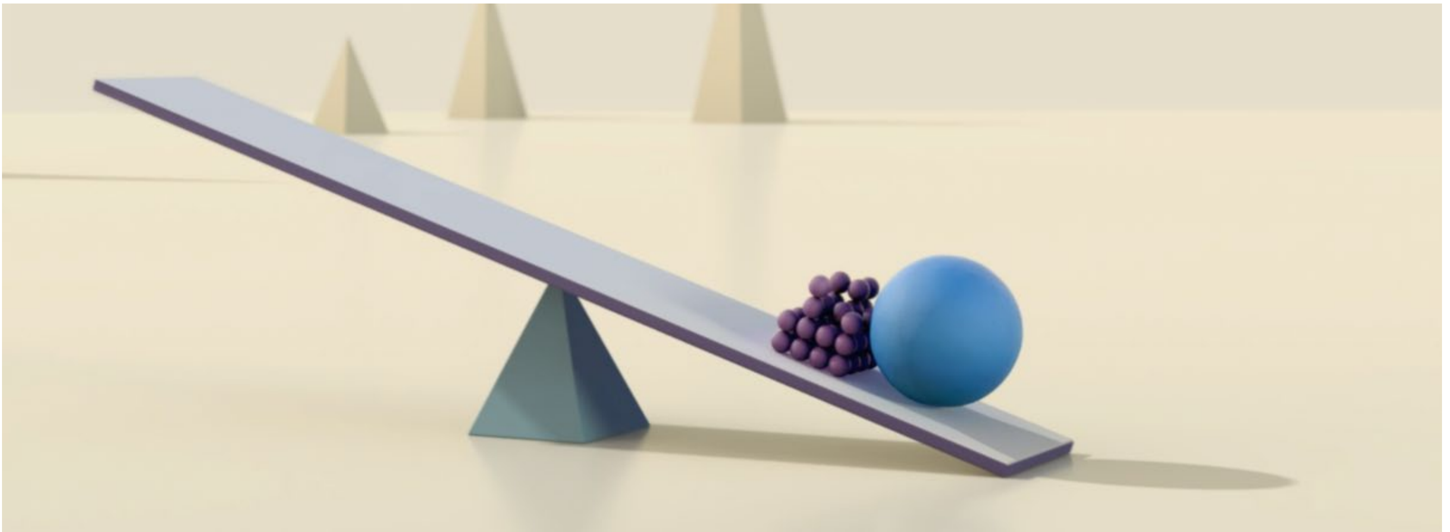

Learning the Art of Letting Go

When you stick with a financial decision only because you're afraid of losing money, you may end up losing more than you expected

It's not an unusual situation: A person decides to spend a great deal of money updating their family home. "They may really love their house and consider it the place they'll stay forever," says Michelle Spaziani, a Greenfield, Massachusetts-based financial planner. "So investing in that home through renovations may make good financial sense at the time."

But Spaziani has also seen homeowners make those investments, then suddenly change direction. "Especially for those nearing or in retirement, visiting a friend at a new condominium complex may change their mindset. They see the conveniences and built-in social networks that come with these communities, and suddenly that big, single family home—even a newly renovated one—can lose some of its allure."

Spaziani, founder and CEO of Summit Behavioral Wealth, believes it's typically most prudent to sell an existing home before buying a new one. However, the time and money invested in renovations can blur a person's vision of reality: "They may think their newly renovated home will sell immediately and go ahead with the purchase," Spaziani explains.

If an area's real estate market is soft, the homeowner could end up rejecting low offer after low offer because "some people can't accept the idea of losing money by taking a lower-than-expected price for their home, especially after all the work they put into it," Spaziani says.

The unfortunate result: The home may sit on the market for months or even years. In the meantime, the homeowner is paying mortgages for both residences and may even be forced to liquidate other assets to stay financially afloat.

No one likes to lose

This typical scenario demonstrates a common thinking mistake called "loss aversion." Clearly, no one enjoys losing money. However, in a 1979 study, psychologists Daniel Kahneman and Amos Tversky proved that most people actually hate losing money much more than they like winning it. As such, people will do almost anything—including rejecting reasonable home price offers—to avoid that feeling.

Aversion to loss gets even stronger if you put a lot of time and effort into something you own, such as paying for expensive home renovations.

“We sometimes call that the IKEA Effect: When we spend a lot of time assembling that furniture, it becomes even more valuable to us than the price we paid,” says Mariel Beasley, co-director of the Common Cents Lab at Duke University. Her behavioral finance organization studies the mental biases that control people’s decisions about money.

Avoiding loss is just one of many irrational biases that can cause even smart people to make financial mistakes. “Many financial strategies assume that people always act rationally and with total self-control,” Spaziani says. “However, professional financial planners need to pay attention to human behavior, too. We can establish ideal spending and investment plans for clients, but if their mental biases make it difficult for them to stick to a plan, they may not achieve their goals.”

Outsmarting yourself

The good news is that individuals and financial planners can often harness the power of loss aversion to work in their favor, Beasley says.

Some strategies that may work to get past loss aversion include:

Using the cash-out test: Are you holding on to an investment that’s losing money, but don’t want to sell it? Pretend you don’t own the investment but have the equivalent value in cash. Would you use your cash to buy that investment today? Chances are your answer will be no. And if you wouldn’t buy that investment today, you should probably sell it. This simple way of reframing the situation can help clarify your decision.
Setting a time limit: Consider giving a house or stock sale price a deadline to bounce back up. If you don’t get a better price by the end of your time limit, you’ll sell.

Outsourcing your willpower: When you work with a trusted advisor, you can ask them to handle difficult financial decisions on your behalf. A good example is investors who ask their financial advisors to automatically rebalance their investments on an agreed-upon basis. The key: The advisors have discretion with the account, so don’t need to tell the client ahead of time which losing investments they’ll sell.

Purposely using the loss framework: Since people react more strongly to losses than they do to gains, use it to your advantage. For instance, ask your planner to calculate how much you’re losing each day or month by not making a certain financial decision, rather than how much you’ll gain with another choice. “The average person is much more motivated by the idea of losing $25 daily than gaining $30 each day,” Beasley explains.

Financial planners can lower the heat

In the end, Spaziani says, investors are always free to make their own financial decisions, even those who buy a new home before selling the old one. However, she thinks there’s great value in working with financial planners who understand common financial biases and heuristics, and can help investors work through them.

“People are more apt to succumb to financial biases when they make emotional decisions,” Spaziani reflects. “When an investor’s emotions rise like a thermometer, a good financial planner is the thermostat. We can be the rational regulators who help them make less emotionally charged decisions.”

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