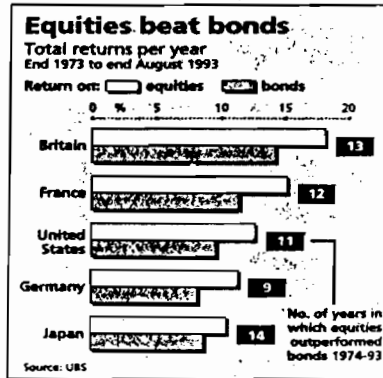


## The cost of looking

**Y**OU are owed some money. You can get it by entering a lottery in which you will win either \$100 or \$50 (an equal chance of each). Or you can have a guaranteed \$51.20. You enter the lottery, right?

One of the best-known facts of investing is that, over the long run, equities outperform bonds (see chart). In America, the total annual real return on shares averaged 7% between 1926 and 1990, that on Treasury bills less than 1%. Often this gap (or "equity premium") is explained by saying that equities are more risky than bonds—returns on them jump up and down far more than do those on bonds—so investors need a higher rate of return to compensate them for bearing that extra risk. That seems to make sense for short-term investors, who might have to bail out of an investment in a hurry. But since many investors buy for the long term, the fear of risk could only explain that equity premium if the average investor were as cautious as the gambler who hesitated between the lottery or the certain \$51.20.

So is there a better explanation for the equity premium—or, indeed, for why long-term investors have any bonds whatsoever in their portfolios? Yes: it is called "myopic loss aversion", suggest Shlomo Benartzi and Richard Thaler, two Cornell



University economists, in a new study\*. "Myopia"? Even if investors are saving for the long term, they still care about how their assets do in the short term. "Loss aversion"? They dislike a fall in the value of their assets more than they like an equal rise in value. The more myopic an investor (the more frequently he values his assets), the more his aversion to loss will make him prefer the stable but lower returns offered by bonds.

The authors assumed that investors had a "loss-aversion factor" of 2.25: that is, in a lottery they would need to have a 50% chance of making \$2.25 in order to

risk losing \$1. They derived this measure from assorted psychological tests on investors. Looking at monthly data in America from 1926 to 1990, they then asked how often an investor with myopic loss-aversion would have had to look at the value of his assets for the bigger and more frequent losses on shares to push him into demanding the equity premium that the market actually provided. The answer, they calculated, was around once a year. That tallies roughly with how often individual investors fill in their tax returns, and company pension plans compare their performance with the industry benchmark.

What if the investor had valued his assets less often—say, once every 20 years? He would have needed to earn only an extra 1.4 percentage points a year on equities, the study calculates, to overcome his aversion to loss and put all his money into shares—or around five percentage points less than the actual equity premium. That sum, it concludes, is the reward for long-term investors who resist the temptation to count their money often. If you are saving for retirement, your best bet is to buy a portfolio of stocks, put it under your bed, and forget about it.

\*"Myopic Loss Aversion and the Equity Premium Puzzle", by Shlomo Benartzi and Richard Thaler, NBER, 1993