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The Impact of Regret

"A lifetime of making choices brings with it the knowledge that at least some actions were ill-considered, some failures to act, unwise. For most of us, it also brings with it the realization that some of these unfortunate outcomes could have been avoided. To live, it seems, is to accumulate at least some regrets."

- The Experience of Regret by Gilovich and Medvec

Alfred Bernhard Nobel was born in Stockholm, Sweden in 1833. He was a Chemist, Engineer and an Inventor and held 355 patents to his name. In 1867, while experimenting with explosives, he discovered a mixture that had high explosion capabilities and was easy to handle. He named the invention "Dynamite" after the Greek word "Dynamo" which means power. He set up huge factories to manufacture and supply the same and acquired a fortune as humanity used his invention for construction and war.

In 1888, Alfred's elder brother Ludvig died. The day after his death, Alfred was going through the newspapers to read the obituaries written for his brother. He realized that some newspapers had mistaken him to have died instead of his brother. In one of the newspapers, the obituary started with the line 'The Merchant of Death has died.' It condemned him for his invention of military explosives that led to so many deaths. Alfred was disappointed with what he read. It is widely believed that the moral regret that he felt about his invention, led him to donate bulk of his wealth to a fund which was to be distributed in the form of Nobel Peace Prize.

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When we take a decision and it does not lead to a good outcome, we go into self-recrimination. We think about all the options that we should have chosen or ideas that had prompted us to avoid the option we chose. This emotion, commonly known as 'Regret' is almost like inflicting punishment on ourselves. Clearly, we go to great lengths to counter this emotion as well as to avoid it. Regret and regret aversion both impact our decision making in personal life and in investing.

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Regret affects the choices we make in investments in many different aspects. I have discussed some of the important ones in this article.

REGRET – NORMS AND STYLES

Consider two people Mr. A and Mr. B:

Mr. A regularly prefers to invest in fixed income securities issued by high-quality companies. He has no investments in Equity. Recently, as interest rates declined significantly, he bought some stocks, but they are currently below his purchase prices.

Mr. B regularly invests in stocks. He bought some stocks recently which are currently in the red.

Who feels more regret? Most people will point to Mr. A. When people act out of character or outside their comfort zones, the regret is higher. New investors entering the equity market may suffer a loss and regret their decision. Their future decision on asset allocation will be impacted by this regret. The above situation can be considered in different version of assets or styles too. Imagine if Mr. A is regular investor in large cap Bluechip stocks and dabbles in smallcap for the first time and loses. Mr. B may not have much regret is he is a regular investor in smallcap stocks. Or consider Mr. A and Mr. B are portfolio managers following value investing and growth investing styles respectively. Now replace the fixed income products in the above case with value stocks (for Mr. A) and equities with growth stocks (for Mr. B). Regret of moving away from value style to growth and taking a loss is likely to be very painful for Mr. A.

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REGRET AND RESPONSIBILITY

Consider three people Mr. A, Mr. B and Mr. C:

Imagine that the equity markets have come off sharply. Mr. A has a large amount of deposits maturing and has to renew them. He considers buying equities as he thinks markets will rebound. However, he nevertheless decides to renew his fixed deposits.

Mr. B who is heavily invested in equities and, on his own analysis, decides to sell equities and move into fixed deposits.

Mr. C is in a similar situation like Mr. B and transfers money from equities to fixed deposits. Although the only difference is that he does so under the advice of a financial consultant.

The stock market rebounds by 15%. Who feels more regret?

Hersh Sherfin talk about this situation in the book 'Beyond Greed and Fear'. He says, most people choose Mr. B as having the most regret. Although all of them missed the market rally, Mr. A continued with his default or conventional allocation. And inaction causes less regret than action (in the short term). Mr. C was in the same situation as Mr. B, but he is not completely responsible for this decision. He was advised by someone else. Ironically, taking the blame and reducing Mr. C's regret is an important service provided by his financial consultant. Mr. B, of course, took the action to change and that too completely on his own. He feels the most pain. This is because the pain of regret depends on the degree to which the person making the decision feels responsible.

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One of the ideas to reduce regret by sharing responsivity is to have rules (or an investment process). If one makes any changes, guided by the rules that have proven helpful majority of the times, the regret and the subsequent negative influence of the experience are lower.

REGRET AND HINDSIGHT

This misery comes with a companion. Typically regret comes with hindsight bias. When we evaluate our decisions, we choose to compare the option we chose with the alternative that turned out to be the best choice in hindsight. Let's use a recent example: A lot of investors regret not investing some money in equities in March 2020 when the markets fell but, they continued their default investment in bonds which yields 7%pa. The range of Nifty index in March 2020 was a high 11300 (<1% away from yesterday's levels) and 7600. Of course, investing during market correction is generally profitable. However, when investors evaluate their decision, they compare their lost opportunity with the lowest level of nifty in March 2020 than anywhere in between, showing uncanny confidence in timing the market exactly (investing at 7600) in hindsight. Also, they will tend to under appreciate even the most valid arguments that shaped their decision at that time.

There are many investors who identify certain areas of investment (stocks, sectors, industries, factors) as their strengths. These form a part of their circle of competence. To err in one's circle of competence causes more regret than the one outside purely because in hindsight, one feels it seemed like an easy decision.

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This affects contrarian investing too. It takes a lot of emotional strength to go against the crowd. If one takes a contrarian call and buys an underperforming stock and suffers a loss, the hindsight bias can be disturbing. The arguments to not make that investment can easily come to one's mind due to hindsight bias.

REGRET AVERSION AND RISK AVERSION

Because regret is a painful emotion, we do our best to try and avoid it. That leads to risk aversion. Consider the Allais Paradox:

Choose between option A & option B in the following problem 1
Option A: 20% chance to win Rs. 400,000
Option B: 25% chance to win Rs. 300,000

Now choose between option C & Option D in the following problem 2
Option C: 80% chance to win Rs. 400,000
Option D: 100% chance to win Rs. 300,000

Option A and Option C have superior expected value to their counterparts. One would expect person choosing Option A in the first problem to choose option C in the second. However, a lot of people who choose Option A in the first problem choose Option D in the second one. This is mainly to avoid the regret of missing a sure Rs. 300,000 in problem 2.

Regret aversion makes people risk averse and stick to conventional ways. In the Money magazine interview, Harry Markowitz, who won a Nobel Prize for developing the Modern Portfolio Theory (developing ideas to choose the right portfolio) was asked about his personal money allocation strategy. He replied, *"My intention was to minimize my future regret. So, I split my contributions fifty-fifty between bonds and equities".*

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The Netherlands Post Lottery is one of the best examples of decision making for regret aversion. Here, one buys a lottery ticket which has the pin code on the ticket. The draw is not about a particular lottery number but a pin code of the area. All the participants who bought the lottery in the winning pin code get a prize. The lottery was an instant success because of regret aversion. People imagined their regret if they did not buy the lottery and if their area code was selected and their neighbors won.

MANAGING REGRET

Making decision that are based on the regret of the previous decision can lead you into trouble. At the same time, we may make suboptimal choices to avoid future regret. The simple steps that can help manage regret according to me are: Draw up a good investment process, follow it with discipline and expect errors.

- I had mentioned earlier how rules help reduce regret. Collecting these rules which work (most of the time) in generating good returns and putting them together in a proper lineup (stages or steps) is your investment process.
- I also mentioned that actions create more regret than inactions in the short term. Gilovich and Medvec have written an excellent research paper where they prove that in the long run however, inaction create more regret. In case of investments, when investors have a good process and the inaction of not following it with discipline can become the biggest regret.

- *No investment strategy or style or process works 100% of the time (as far as I know). Expect that there will be some decisions where you will not get the desired outcome. That should help reduce the regret.*

As Shakespeare once said, *"Let's not burden our remembrance with a heaviness that's gone."* Don't let regret or regret aversion guide your actions (or inactions).

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ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).