Applied Emotional Intelligence: Regulating Emotions to Become Healthy, Wealthy, and Wise

This chapter is going to be a little different from many of the others in this book. Rather than talk about emotional intelligence per se, I am going to discuss two particular applications of what we have learned about emotional intelligence. The focus will be on staying physically well and on making good financial decisions—health and wealth. I am going to argue that the appropriate regulation of emotions is an important predictor of good health and a key to investing money wisely.

The view of emotional intelligence that forms the backdrop for this chapter is that of Mayer and Salovey [1–4]. This theory describes emotional intelligence as a set of interrelated abilities organized along four dimensions: (a) identifying and expressing emotions, (b) using emotions, (c) understanding emotions, and (d) managing or regulating emotions. Although all four of these sets of skills may be important in staying healthy and accumulating wealth, in this chapter I focus only on the last of these four, managing one’s feelings.

☐ The Salubrious Consequences of Emotional Regulation

You are driving on the interstate and a car cuts in front of you at 70 miles per hour. Then the driver jams on the brakes. You do the same and feel
yourself becoming enraged: “Where did this guy get his driver’s license? Sears?” Emotional challenges like this one present themselves every day. Should I express my anger—perhaps rolling down the window, yelling, or gesturing obscenely? Or should I “sit on” my emotions, suppressing this until, it would seem, they go away? The challenge of expressing versus suppressing is a fundamental dimension of emotional self-management. And I am going to argue in this section of the chapter that emotional expression and emotional suppression represent a double-edged sword: both strategies can lead to health problems.

**Emotional Expression and Health Outcomes**

How would you answer the following questions? True or false? “Some of my family members have habits that bother and annoy me very much.” True or false? “I tend to be on my guard with people who are somewhat friendlier than I had expected.” True or false? “It makes me feel like a failure when I hear of the success of someone I know well.” People who answer “true” to questions like these tend to be prone to hostile, angry outbursts [5], and the tendency to respond to social situations with hostility seems to be associated with coronary heart disease [6–7].

What is interesting in this line of research is that it is not just any kind of hostility and anger that bodes poorly for the health of one’s heart, but rather, a particular kind: cynical hostility. Cynical hostility is a specific example of the failure of emotional self-management. It is characterized by suspiciousness, resentment, florid displays of anger, antagonism, and distrust. These folks are not hard to find in a crowd. More often than not, they are men [8]. They tend to be verbally aggressive and behaviorally antagonistic. Not surprisingly, they have difficulty making friends or maintaining relationships [9–10].

All of this cynical hostility takes it toll on the heart. First of all, it creates excessive cardiovascular reactivity. The heart and vascular systems tend to over-react to minor stressors [11], and this is especially true in situations involving other people [12]. The blood vessels feeding the heart muscle tend to constrict, while the heart itself beats faster. This puts a real strain on the coronary system. The emotional arousal often experienced by cynically hostile people is associated with lipids being shunted to the bloodstream (perhaps to provide “fuel” for the ensuing fight that the body is expecting). This increase in blood cholesterol and triglycerides creates a risk for the buildup of plaques, which can block arteries feeding heart muscle and result in a heart attack [13]. Worse in some ways, when people are experiencing a lot of anger and hostility, they may cope with it by smoking cigarettes, drinking alcohol, or eating fatty foods, which can lead to longer-term health damage too.
Emotional Suppression and Health Outcomes

So, is the answer simply to “stuff it”—to suppress hostile feelings, maintain a calm exterior, and minimize the expression of negative emotions? That strategy does not appear to be very healthy either [14]. For one, suppressed anger seems to raise one’s blood pressure just as much as expressed anger [15]. It is also possible—though the evidence is quite weak at this point—that suppressing negative emotions may increase susceptibility to and progression of cancer [16–18]. In fact, the course of the illness among cancer patients who are openly angry and combative may actually be better than for those who suppress their anger [19–20].

Denial and repression, on the other hand, may be related to cancer progression [21]. In one set of studies, recent stressors and coping abilities were measured in over 1500 women sent to a specialist because of a lump or tenderness in a breast. Those women who were experiencing the most stress, but at the same time denied its existence, were especially likely to be diagnosed with breast cancer. However, women who indicated that they were comfortable expressing anger were less likely to receive this diagnosis [22–24]. So, acting like the stressors in one’s life are not bothersome may be dangerous to one’s health. And, at least in the breast cancer context, expressing anger might protect a person from cancer. Again, it looks like anger is a double-edged sword. Too much results in one kind of health problem; too little, another.

Luckily, we can learn to express the right amount of anger. David Spiegel and his colleagues at Stanford University enrolled women with metastatic breast cancer into a support group that met weekly and, in part, helped women to learn to express their feelings about having cancer, extract meaning from the experience, and develop a social support system [25–26]. A control group received only standard medical care. Those women who participated in the support group lived an average of 37 months from the start of the study; those women who received only standard medical care died, on average, after only 19 months. Unfortunately, recent work on expressive group therapies for cancer patients has produced a more mixed set of findings (e.g., [27–28]).

Confiding: Might This be the Answer?

If expression of cynical hostility is related to heart disease but suppressing emotions may be associated with cancer progression, what is a person to do with such feelings? Perhaps the Greeks were correct in urging moderation in all things. We may need to express negative feelings, but in a way that is neither mean-spirited nor stifled. It is likely that this is what he had
in mind when Jamie Pennebaker at the University of Texas proposed that confiding our traumas may have beneficial effects on physical and mental health. Pennebaker has studied the effects of emotional disclosure extensively and finds that the simple act of disclosing emotional experiences in writing, even anonymously, improves individuals’ subsequent physical and mental health (see [29] for a review). For instance, students assigned to write about a traumatic emotional experience subsequently made fewer health center visits and received higher grades than students assigned to write about a trivial topic (e.g., [30–31]). The benefits of emotional disclosure also include broadly enhanced immunological functioning (e.g., [32]), and decreases in self-reported physical symptoms, distress, and depression (e.g., [33–34]). These impressive findings have proved robust across dozens of studies conducted by several investigators and among such disparate populations as college students, maximum-security prisoners, and recently unemployed professionals (see [35] for a meta-analysis).

**Learning to Regulate Our Emotions for Better Health**

Perhaps the expression of emotions has only a positive impact on physical health when we are confident about our abilities to regulate them. In one study, we investigated the hypothesis that adapting successfully to a stressful experience depends, in part, on beliefs that one has the capacity to regulate feelings. Goldman, Kraemer, and Salovey conducted a prospective study examining whether beliefs about one’s moods, in particular, the belief that one can repair negative moods, are related to physical health complaints [36]. The reasoning behind this study was that individuals who cannot repair or regulate their feelings may look to others for help in doing so. As a result, they may be more likely to seek the attention of a physician when they are feeling stressed because they do not know how to regulate these feelings themselves. Such individuals may simply be using the health care system as a mood regulation strategy. Of course, it is also possible that these individuals are actually more likely to become physically ill when stressed.

Goldman et al. assessed 134 student volunteers at three different times during the semester: at the start of the year, during midsemester examinations, and during final examinations [36]. At these times, Goldman et al. administered the Trait Meta-Mood Scale (TMMS), which includes an index of one’s beliefs about being able to regulate feelings, as well as measures of stress, physical symptoms, and health center visits [36]. When the researchers divided the sample into three groups of people (those with a high degree of skill in repairing negative moods, those with average skills in this area, and those with low skills), they found some...
intriguing results. When stress was low, the three groups differed very little. But, as stress increased, those individuals who said that they could not easily regulate their feelings were more likely to visit the health center, and those individuals who were good at repairing negative moods actually visited the health center less often.

Summing Up

Affective self-regulation appears to be the aspect of emotional intelligence most relevant to physical health [37]. As we have seen, individuals unable to control their anger and hostility are prone to heart disease. The data connecting hostility to cardiovascular problems are quite strong. At the same time, individuals who suppress their anger and hostility—and negative feelings more generally—may be engaging in an emotional style that exacerbates certain kinds of cancer. However, the data linking suppressed negative emotions, like hostility, to cancer are, at present, not nearly as convincing as that linking hostility and heart disease. In general, the inability to regulate negative emotions, indeed, even the belief that one does not have strong skills in this domain, seems to make one vulnerable to stress. When the going gets tough, the tough get going; but when the going gets tough for individuals who lack confidence in their emotional regulatory skills, they are more likely to end up going to the doctor’s office.

The Emotionally Intelligent Investor:
Avoiding the Pathologies of Loss Aversion

It’s January. You’ve paid off your holiday bills. For the first time in years, you have some extra cash—$4000 to be exact. Usually you would just add this to your savings account, but you’ve noticed of late the paltry 2% interest rate the bank is paying. Maybe there is a better place to invest your money. What about the stock market? You read a book last year suggesting that even non-experts like yourself can make money in stocks, just invest in what you know. Well, you know about General Motors; you have a 1993 Chevrolet parked in the garage and a 1997 Pontiac in the driveway. And your daughter works as a hostess in that new restaurant in town, the celebrity-endorsed Planet Hollywood. It always seems pretty crowded there when you drop by to see how she is doing.

So you set up an account with one of those web-based brokerages on your home computer and buy $2000 worth of General Motors (50 shares at $40 each) and $2000 in Planet Hollywood (100 shares at $20 each).
For a while, nothing much happens one way or the other. You check your stocks every day; they go up, they go down. But over a few months, you notice a trend. General Motors seems to be creeping up just a bit, but the overall inclination of Planet Hollywood seems downward. After 6 months, General Motors is now worth $50 a share and Planet Hollywood $16.

"Time to make some decisions?" you wonder. You think about the situation with General Motors. In just a few months, you’ve made $500 on a $2000 investment. “Pretty good,” you think to yourself. “Let’s lock in that gain and sell it.” You log on to your broker, type in a sell order, and find that you have $2500 in cold hard cash, minus a few dollars commission. “This is pretty easy,” you think to yourself. “But what about Planet Hollywood?” Your $2000 investment there is now worth only $1600. You mull over your options and decide, “why turn a $400 loss on paper into a real loss by selling? Might as well just hold on. Planet Hollywood will turn around. If it doesn’t make a big run, I’ll hang on at least until it drifts back to $20 a share. When I’m even, I’ll sell it. Besides, I think Planet Hollywood is a pretty good restaurant. I am sure others will see how wonderful it is before too long. Maybe I should think about buying some more shares using some of the money in our household emergency account. Probably best just to sit tight.”

Do these investment ruminations ring a bell with you? Most experts in behavioral finance and investor psychology would suggest that they’ve led to precisely the wrong choices (e.g., [38]). That selling winners quickly and hanging on to losers for a long time waiting for them to turn around are defeatist strategies. That taking risks in order to get out of a hole no matter how compelling is not an emotionally intelligent decision. That overvaluing what we already own is commonplace but irrational. And that making no decision at all— maintaining the status quo—often feels like the easiest decision to make, the path of least resistance. This section of the chapter explores some of the reasons why investors make these kinds of decisions and argues that by intelligently managing our emotions—our pride and, in particular, by not being quite so afraid of feeling regret, we may be able to make more profitable choices.

Prospect Theory

Obviously people feel better when their investments rise in value than when they fall. But why is it that, say, a 20% gain only makes us feel pretty good while a 20% loss leads to wretched misery? Winning some amount certainly brings pleasure. But take that same amount and lose it; now we feel truly horrible. Before we can understand the investor
pathologies described in this chapter, we need to appreciate this emotional imbalance.

How are we to comprehend this asymmetry between how winning and losing makes investors feel? We need to consider one of the most influential theories in both behavioral economics and psychology. It is called *prospect theory*, and it was articulated by Stanford University’s Amos Tversky and Princeton’s Daniel Kahneman. Although this theory has profound and complex implications, its essence can be captured in a single graph that looks like an “S.” This graph, depicted in Figure 11.1, relates outcomes in the world—such as gaining or losing money—to how they make us feel, their subjective value [39–40].

There are a few things to notice about this graph. First of all, if humans were completely rational creatures—mechanical androids like Commander Data on Star Trek—the figure would not be an S-shaped curve at all but rather a straight line. Every dollar gained makes us one unit happier; every dollar lost makes us one unit sadder. In terms of its influence on

![Figure 11.1. The value function of prospect theory.](image)
our emotions, each dollar is like every other dollar. But this is not the case. As we "win" dollars, each new dollar adds less to our enjoyment than the previously won dollar. The first few dollars gained make us feel the best. No reason to take any risks in order to gain more dollars, once we've won a few, we already feel pretty good, right?

Now take a look at the left side of the graph. Here, with each dollar lost, we feel worse and worse, but the losses that pack the strongest negative punch are those first few dollars lost. We already feel pretty badly when we lose, so if we lose more, we only feel a bit worse. If we are losing, perhaps we might as well take some risks: we are already feeling pretty badly, so who cares if we lose more?

There is something else that is interesting about this graph. Notice how the "S" curve is not as steep for winning as it is for losing. Start at the middle of the graph—called the "reference point"—and notice what happens to one's feelings as you move the same distance right (gain) or left (loss). The negative emotional reaction to losing is always bigger than the positive emotional reaction to gaining the same amount. A $5 win is okay, but a $5 loss is sad. A $10 win is nice, but a $10 loss is miserable. A $1000 win is terrific, but a $1000 loss is total tragedy. As psychologists like to say, losses loom larger than comparable gains.

So why am I taking so much time telling you about this graph? Well, this simple S-shaped curve helps us to understand several classic and interrelated investor mistakes and the emotions that drive them: (a) refusing to sell losing investments but selling winners prematurely, (b) taking bigger and bigger risks when losing in order to "get even," (c) overvaluing an investment simply because we own it, and (d) staying with the investments we already have, that is, preserving a bias toward the status quo. In the remainder of this chapter, we discuss each of these emotionally rooted investor pathologies.

Refusing to Sell at a Loss

Some years ago, a manufacturer of sports apparel moved to New Haven, Connecticut, the city where I live. This company provides uniforms for many professional sports teams and also sells t-shirts and sweat clothes to the general public. With great fanfare, this company "went public," selling stock in an initial public offering for about $24 a share. Wanting to support a local employer and get in on this action, I began to follow the stock price of this company. When it dropped to about $12 a share a year later, I bought 500 shares. At half the initial offering price, it seemed like a bargain. The price of this stock, however, never saw $12 again. Over the next several years, in the face of labor problems in professional sports
leading to strikes and shortened hockey and basketball seasons, it dropped to $6, then to $3, then to $2, and finally bottomed out near $1. A $6,000 initial investment was now worth a bit over $500.

As this situation unfolded, it would have been adaptive to have asked, "Is there a better place for my money?" If yes—and these were years when the market as a whole was rising dramatically, so nearly any investment alternative may have been better than this one—the rational thing to do was sell the stock, despite the loss, and put the money to work somewhere else. In fact, some money managers have a "stop-loss rule," that says if their initial investment drops in value more than some predetermined amount, often 10%, sometimes a bit more, they sell it. Period. No questions asked. But I would not be telling you about this particular investment if that's what I did. Instead, refusing to admit I was wrong about this company (even though I read their annual reports indicating negative earnings year after year), I hung on. "Why turn a paper loss into a real one?" I would tell my wife. "Some day, when all these strikes in professional sports end, I'll get even. Then I'll sell."

Well, this story has an interesting ending, which I will describe later when I talk about the pathology of risk taking in the face of losses. But for now, let me discuss the emotional turmoil that plagued and paralyzed me. Investment guru Leroy Gross in The Art of Selling Intangibles: How to Make Your Million $ Investing Other People’s Money [41] captures it very well:

Many clients will not sell anything at a loss. They don’t want to give up the hope of making money on a particular investment, or perhaps they want to get even before they get out. The “genevemis” disease has probably wrought more destruction on investment portfolios than anything else. . . . Investors are reluctant to accept and realize losses because the very act of doing so proves that their first judgment was wrong.

This is called loss aversion, the reluctance to accept a loss [40], [42]. And it can manifest itself in two ways: the tendency to hold on to an investment that has declined in value for much too long, and the tendency to sell an investment that has appreciated prematurely. In other words, rather than stopping losses but letting profits run (as is usually advised), we are emotionally wired up instead to refuse to cut our losses with a bad investment and fail to take full advantage of a good one. Behavioral economists Hersh Shefrin and Meir Statman note, we “sell winners too early and ride losers too long” [43].

Refusing to sell losers and invest our money elsewhere is especially interesting, given that the IRS rewards us with a nice tax deduction if we could bring ourselves to admit we were wrong and sell that losing stock. But no, we hang on. Pride goeth before a fall; why admit we made
a mistake by turning a paper loss into a real one? And hope springs eternal: if we hold on just a little longer, we know that the investment will turn around.

The best way to understand this investor pathology is to consider, once again, the S-shaped curve. Notice how as one contemplates a gain—the right side of the figure—the curve from the reference point (the center) is concave, but that as one contemplates a loss—the left side of the figure—the curve from the reference point is convex. They way in which the curve flattens out for both gains and losses reflects the fact that once feeling good about a gain, it is hard to feel much better with additional gains, and once feeling pretty bad about a loss it is unlikely one will feel even worse with additional losses. Hence, why not sell gainers and “lock in” these good feelings now, without risking that they could go away.

And why not hang on to losers, after all, how much worse could I feel? Sounds like a good emotional self-regulation strategy, no?

An emotionally intelligent investor might look at the tendency to hang on to losers but to sell winners in yet another way: as a battle between pride and regret [43–44]. The potential pride in selling an investment at a profit (“I was right!”) is offset by the even stronger emotion of regret when one contemplates selling an investment at a loss (“I was wrong”). We are delighted to experience pride whenever we can, and hence sell our winners when, perhaps, we should hold on to them. But we will work very hard to avoid experiencing the more powerful emotion of regret. As a result, we postpone selling losers. Richard Thaler suggests that “the regret at having erred may be exacerbated by having to admit the mistake to others, such as one’s spouse or the IRS” [44], an admission that never has to be made if one refuses to sell! Not surprisingly, then, an analysis of the accounts of 10,000 individual investors with a particular brokerage firm revealed that these investors were 50% more likely to sell a stock that had gone up as compared with one that had gone down [45]. In this analysis, if each investor had sold a loser rather than a winner, on average they would have made 4.4% more profit in the subsequent year. But, “forgone gains are less painful than perceived losses” [46].

Emotionally intelligent investors can benefit from the advice of legendary Wall Street executive Alan G. (Ace) Greenberg, the chairman of the investment firm Bear Stearns. Considering his father’s approach to selling clothing retail through a chain of stores in the Midwest, Greenberg says:

If you’ve got something bad, sell it today because tomorrow it’s going to be worse . . . People don’t hesitate for a minute to take a small profit, but they don’t want to take losses. Which is, of course, just the opposite of what you should do. If you’re wrong, you’re wrong. Sell and buy something else. (quoted in [47])
An emotionally intelligent way to get over the concern about feeling regret when a losing stock position is sold is to reframe what one is trying to do. Rather than thinking in terms of selling a loser and buying something else with the proceeds, reframe this decision as the transferring of money from one investment to another. Don't even use the word "sell," in describing what you are doing. You are simply reallocating investments, not "buying" and "selling."

**Risk Taking When Confronted by Losses**

In one of their early papers on prospect theory, Kahneman and Tversky observed that "a person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise" [39, p. 287]. Because losses are so painful, investors are motivated to take risks as a way to avoid them. Think about casino gambling for a moment. It is very hard to walk away from the table a loser, isn't it? But suppose that luck wasn't much of a lady for you last night, and today is the final day of your vacation in Atlantic City. What are you most likely to do? Frequently, people will head back to the casino and try one last time to get even. Now, because the essence is that they are already so far in the hole, they take much bigger risks—betting at the $20 blackjack table rather than the $5 table. Investors often engage in similar behavior—buying more and more of a loser as it drops in price hoping that if there is a price turnaround, they'll break even. Perhaps also, they are attempting to demonstrate to themselves (and anyone who is watching) that they did not make a mistake, that they have no regrets. Peter Lynch calls this, "watering weeds" [48].

Now, if you really believe in the fundamental value of your investment—it's an excellent company, in a growing industry, with quality management—but that it is just going through a temporary difficult period, by all means buy more of it. What was a good deal at $20 per share is an even better one at $10, right? Alas, often decisions to buy more do not represent taking advantage of temporary discounts—a New York Stock Exchange Fire Sale—but rather throwing good money after bad.

Recall my investment in the New Haven sports apparel company that I purchased at $12 and that sank like a stone for the next several years thereafter. How should I have handled that mistake? No doubt, when the stock dropped some predetermined amount—say to $9 or $10—and there was no reason to believe that the fundamental value of the company in terms of sales or profits was going to improve quickly—I should have cut my losses and sold. True, $6000 would have turned into $5000, or even less, but the loss could be used to offset gains at tax time. More
importantly, the question to ask is “if I had $5000 to invest, would I buy shares of this company or put the money somewhere else?” No doubt, other options would have appeared to be better investment opportunities.

But is this what happened? Alas, no. Desperate and not being able to admit my folly by “booking” the loss, I bought more of the stock—at $6. Then at $4, and then again at $2. With no hope on the horizon for this company, the value slipped to $1 per share, and now an approximately $15,000 original investment was starting to look pretty worthless. With an overwhelming case of “getevenitis,” I bought a final 2000 shares at $1.25 each. Over the next several months, the stock price bounced around between $1.00 and $1.75. The likelihood that this company would ever make a profit was in great doubt. Maybe it wouldn’t even survive. What was bad, only got worse.

This gamble paid off, but only because of a small miracle. Scanning the stock quotes on my office computer one afternoon (while I should have been working), I noticed unusual activity in the stock of this company: massive amounts of buying and selling. Volume was hundreds of times greater than normal. And the price was going up—$2, then $3, then $4—all in a matter of 15 minutes. At just under $5, I sold everything I had, a small profit, actually. For five more minutes, the stock rose, to 6, 7, and 8 or so, but then, just as quickly, it sank back to $4. One day later, it was trading at $2, and within a week it was back around $1.50. The company has since gone into bankruptcy and was “delisted” by the stock exchange.

What caused this unusual activity? It is not really clear—the company made no announcements during this period, and it was not covered in the financial media. Perhaps day traders were churning the stock and then lost interest. No one is quite sure. For me, the end of the story is a relatively happy one: I got out alive—after several years of stress—although my money during this time could have done much better invested elsewhere. But for every minor miracle of this kind are dozens of stocks that continue to sink and never rise to the level at which they were purchased. Should you sit around waiting for such lightning to strike in order to sell them? I don’t think so. Get out. Put your money somewhere else. Pretend you had the cash in hand that you would if you could sell the investment; would you now invest that cash in this company? If the answer is “no,” it probably is, “book” the loss.

The tendency to take big risks when losing, hoping against hope that one can get out from under the loss, results in investors throwing good money after bad. They are engaging in what is called a sunk-cost strategy [44], [49]. The more money we have thrown at some idea—consider how I continued to throw money at the losing sports apparel stock—the more we ignore associated risks and justify throwing even more money at it. At
very owner of an old car knows, the reason for not selling your jalopy is
hat you just put $500 into a new exhaust system for it (despite knowing
hat the transmission is likely to go next, and that will be even more
expensive to fix). The emotional power of sunk costs is illustrated at the
heater when we do not leave at intermission even though we are not
enjoying the play, at restaurants when we overeat simply because the meal
was expensive, and at the department store when we value something
more after paying full price than when we purchase the same item on sale.

The Endowment Effect: If It’s Mine It’s Worth More

losers are the hardest investments for us to get ourselves to sell. But, in
act, we have emotional difficulties selling anything. The subjective value
of what we own (that is, its value to us) is always higher than its actual,
objective value (its price in the marketplace). This is called the endow-
ment effect; investors overvalue what they own and devalue what others
own. More formally, people demand much more to give something up
than they would be willing to pay to buy it [44].

If humans were the rational automatons on which traditional economic
theory is based, the value of something would not change depending on
whether one owned it or not. I should be as willing to sell my laptop
computer for $1500 as I would be willing to buy the exact same one from
my neighbor at the same price. But this is not what happens. I want
$1800 for mine, and I wouldn’t touch my neighbor’s for more than
$1200. Similarly, people fall in love with their investments, especially
stocks and mutual funds, and have great difficulty parting with them.

The endowment effect is another implication of that S-shaped function
of prospect theory, described earlier in the chapter. It is a kind of loss
aversion. Because of the extra emotional impact associated with losing
something as compared to winning it, we have strong motivations not to
lose things—not to let go of anything we have. This behavior is often seen
among homeowners who sell their houses without help from real estate
brokers. These FSBO—For Sale By Owner—homes are often priced above
the market because their owners so desperately want to avoid the regret
associated with accepting too low a price, and there is no broker to
encourage them to set a more realistic figure. How many of you know
someone who refused to sell their house, despite a reasonable offer, hop-
ing to get full price (even with a broker encouraging them to accept) only
to find that a better offer never materialized?

The endowment effect is easily demonstrated in the laboratory. For
example, suppose I recruit individuals to participate in one of my exper-
iments and compensate half of them with $1.00 and the other half with a
state lottery ticket. At the end of the experiment, I give the folks who received the dollar the option of exchanging it for a lottery ticket and the folks who received the lottery ticket the option of exchanging it for a dollar. It turns out that most individuals, regardless of whether they first received a dollar or a lottery ticket, are reluctant to give it up in exchange for the alternative option. Because they own it, it is now worth more to them (after $50). Similar results have been obtained for individuals given coffee mugs or ball-point pens; for mugs, the average “owner” was unwilling to sell for less than $5.25, but the average “buyer” was unwilling to pay more than about $2.75; the ratio of selling to buying prices for pens was also about 2 to 1 [51].

Perhaps in the most dramatic demonstration of instant endowment, George Loewenstein and Daniel Kahneman gave half of the students in a class a nice ball-point pen and the other half a token redeemable for a mystery gift. Everyone was then asked to rate the attractiveness of various possible gifts and then to choose between a pen and two chocolate candy bars. Fifty-six percent of the individuals who already had a pen preferred it as the gift of choice, but only 24% of the others chose the pen. However, when everyone rated the attractiveness of the gift options, the people given a pen did not rate it as more attractive than those who did not get one. It appears that the endowment effect is driven more strongly by the emotion of regret at having to give something up than an enhanced pride of ownership [52].

The potential impact of regret is so strong that people often make very strange financial decisions merely to avoid regret. For instance, suppose you can choose Retirement Plan A or Retirement Plan B. Last year, Retirement Plan A featured two mutual funds, a very risky small-cap stock fund that returned a whopping 50% and a more conservative blue-chip stock fund with a 20% return. If you select Retirement Plan A, your employer will only let you invest in the conservative blue-chip fund option. Alternatively you can pick Retirement Plan B, which has only one fund, a different conservative blue-chip fund that last year returned 15%. Surprisingly, many people will choose Retirement Plan B, even though its blue-chip fund wasn’t as successful as a comparable fund with Retirement Plan A. Why? Well, to choose Retirement Plan A means to experience the regret of not being allowed to invest in its very successful small cap fund. With Plan B, this non-option is not salient—you don’t see its fantastic return in the quarterly fund report—and regret is less likely to be experienced. In an actual experiment, Richard Thaler found that people would rather win $100 than $150, if winning $150 also meant that someone else won $1000. They’d take less money to avoid feeling the regret at not having been the “big” winner [44]. In this study, regret avoidance was purchased for $50.
The endowment effect creates a bias that plagues investors, making it difficult for them to "pull the trigger" on a transaction. Is it any wonder that manufacturers risk very little when they offer money-back guarantees on their products? Once possessed, these products are worth more than their purchase price to the consumer. The same status quo bias holds, of course, for all kinds of financial products, and so we turn to this issue next.

The Status Quo Bias: Paralyzed in the Present

It all starts to add up: if investors fear selling stocks that have gone down, value what they have more than what they don't have, and are willing to pay a premium not to experience regret, the overwhelming psychological bias must be to do nothing at all. After all, if all of one's ducks appear to be swans, why sell them? And if no one else has anything that is worth what they want me to pay for it, why buy? Besides, if we just hang on, it will all work out, we convince ourselves. Even in the end, Pandora's box contained one last item: hope. As prospect theory's U-shaped function suggests, the disadvantages of change always loom larger than the advantages of remaining in the status quo [46].

The status quo bias may be the dominant emotion management strategy among investors. All things being equal, options that have the appearance of being the status quo—of requiring no change to maintain them—are favored. For example, in one experiment, individuals were told that they would receive a substantial inheritance. Some of these individuals were told that they were to decide on an investment portfolio for these funds (high risk stock, moderate risk stock, treasury bills, or municipal bonds); others were given these options but told that the money was already invested predominantly in one of them. Anticipated returns for each of these options were provided. Both groups were told to allocate the inheritance in any way that they wanted and that they should ignore any tax consequences or possible commissions. The participants who were given a pre-existing portfolio allocation showed a strong bias toward the status quo—they generally left things invested in the way that they already were. For example, 32% of the individuals chose the municipal bond option when no prior investments were mentioned. The number of individuals choosing municipal bonds rose to 47% when they were told that the money they were to receive was already invested that way—when it was the status quo option. The status quo option was especially attractive when the number of investment choices was increased. The more alternatives for investment people were given, the more they simply wanted to leave things alone [53].
Once one decides on an investment strategy, it is important to stick with it. "Stay the course" is a mantra, for example, of the Vanguard family of mutual funds. However, often an investment strategy is selected precisely because it is the course that things were already on, without an active decision that this is the most appropriate one. So avoiding excessive buying and selling is certainly a good investment principle, but only once a strategy has been developed, a strategy that is decided upon actively not merely inherited.

Summing Up

So let's return to our investor from the beginning of the chapter—the person who purchased $2000 worth of General Motors (at $40 per share), only to sell it a few months later when it went to $50 and was worth $2500. What if this investor, who also bought $2000 worth of Planet Hollywood (at $20 per share) and decided to hold on to it, even after a 20% drop in its value, rode her winner, General Motors, but sold the loser, Planet Hollywood, instead?

In today's newspaper, as I write this chapter, is a story about General Motors opening a new luxury car plant in Lansing, Michigan and revealing plans for a new Saturn small sport-utility vehicle to be available in 2002. There is also a column about Planet Hollywood. Under the headline, "Planet Hollywood Spinning Out of Orbit," is a discussion of the restaurant chain's $238 million loss in 1998, reflecting an 18% drop in sales. Accounting firm PricewaterhouseCoopers is quoted as saying they are concerned about Planet Hollywood's ability to continue as a going concern. In May 1999, to pick a date at random, General Motors was selling for $95 per share and Planet Hollywood for 81 cents. We can only hope our hypothetical investor repurchased General Motors but sold Planet Hollywood while it still had some market value.

The trouble, though, is that our psychological instincts and consequent emotional reactions are more likely to lead us to make the same mistakes as this investor. Because realizing losses packs such an emotional punch and forces us to confront the fact, semi-publicly, that we were wrong, it is easier to hang on to stocks like Planet Hollywood, hoping they will turn around and we will get even. Not only that, we tend to fall in love with what we own, and so we are overly optimistic about the prospects of Planet Hollywood despite objective data to the contrary—we might even be tempted to take a risk and buy more in the face of mounting losses and sinking stock prices. Does Planet Hollywood really look like it will be selling around $20 a share in the near future? Finally, because we feel pretty good about having made some money on General Motors, we get out
early, locking in those warm feelings along with a small profit. Regret is no longer risked. Alas, we miss out on even larger gains.

If there is one overarching lesson as we contemplate the pathology of loss aversion and its close cousins—noise, instant endowment and status quo bias—we is that the past tends to be too much with us. We get emotionally hung up on the history of our investments, from whence they came. Ask yourself, “if all my investments were liquidated now, and I had the cash in hand and the freedom to put it anywhere, what would my investment portfolio look like? Where is the best place to put my money for the future?” To the extent that your current portfolio deviates from this ideal one, transferring investment dollars may be desirable—and you should think of it as just that, a transfer or shift of funds. Our emotions are likely to be more cooperative with our investment goals if we think in terms of reallocating our money rather than buying and selling.

**Conclusion**

This chapter has discussed some of the pathologies and advantages of intelligent emotional self-management. In the health arena, appropriate levels of emotional expression may help us to avoid the negative consequences of, for example, anger expression, or of emotional suppression. As for investing, learning to manage regret and anxiety seems like the key to avoiding the pathologies of loss aversion. Emotional intelligence, then, appears to be central to maintaining good health and making the most of the money we earn in life. It is a twist on the old saying, but being emotionally wise may help a person become healthy and wealthy.

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**References**

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