Loss Aversion, Evolution and Risk Complacency

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Since the end of World War II, the U.S. has arguably experienced the greatest era of increasing prosperity in the history of nations. From 1945 to 2001 U.S. GDP and the Dow Jones Industrial Average both increased approximately 50 fold. At the same time, the abundance of and access to resources also increased exponentially.

This increase in wealth has been a huge positive with regard to quality of life. However, it has also been a primary psychosocial driver of a current risk complacent mindset that has left many investors very poorly positioned and extremely vulnerable during this period of economic instability and price volatility.

Making Sense of Loss Aversion

In the 1970's, Daniel Kahneman and Amos Tversky did a series of social psychological studies which strongly suggested that relative to expected utility theory, humans tend to be irrationally loss averse. In other words, we sometimes prefer to avoid the risk of loss even at the sake of a better than fair prospect.

The resulting model called Prospect Theory earned Kahneman a Nobel Prize in Economics and had significant implications among academic economists by challenging traditional economic assumptions regarding humans' roles in markets and rational choice.

But if Kahneman and Tversky's research suggests that humans are irrationally loss averse and appear to inherently act in ways which sometimes undermine their own interests, there must be an explanation.

Psychologists try to make sense of what appears to be irrational.

If someone behaves in a way that appears to run against his/her own well being, perhaps there is some internal logic to the behavior even as it does the subject harm.

For example, let's take alcoholism. Some alcoholics are highly anxious people who began drinking in an attempt to decrease emotional discomfort. And in some cases, such self medicating works for a while and within a very specific environment only to become pathological over time.

So when we ask why someone with great potential would squander it to alcohol, we can then come to some understanding regarding the impetus for the development of the maladaptive behavior if we can discover the underlying anxiety.

I've come to understand Prospect Theory and the general human tendency of loss aversion by thinking about it in terms of human evolution and resource scarcity.

Loss Aversion and Resource Scarcity

For the vast majority of time during human evolution, our biological ancestors lived in an environment in which essential resources were scarce.

So if you wanted to feed your family, you were required to gather or hunt and if there were natural impediments such as extreme weather, you might not survive. Such an environment over countless generations fostered the evolution of the biological basis to loss aversion and helps to explain why Kahneman and Tversky's findings might run counter to expected utility theory.

They did not explicitly account for man's hard wired propensity to protect what was already in hand and the survival value of it. As a result, and from the perspective of survival of the species, we must distinguish between behaviors which accord to expected utility vs. those which accord to adaptation.

Abundance and the Move Away from Our Own Nature

All this brings us back to the discussion which began this missive concerning the unmatched era of resource abundance that has characterized the last 60 plus years in the U.S.

60 years is plenty of time for our preferences and habits as a society to shift drastically but not nearly enough time for evolution to influence our biology. So while we remain hard wired for a resource scarce environment, we have been living within a resource abundant one resulting in a collective cognitive dissonance.

Such dissonance, to a large extent, has been seemingly resolved by embracing the material and neglecting the biologically based premium placed on resources.

This has left U.S. culture conflicted, out of step with its own deeper nature and risk complacent

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