'Thinking like a trader' may diminish emotional reaction and aversion to loss

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The late 1990s saw the rise not only of the NASDAQ, the Dow, and the S & P 500, but also of amateur traders—individuals not formally trained to work in the unpredictable world of the stock market—to complement seasoned professionals. Beyond the differences in their credentials, a study led by researchers at the California Institute of Technology (Caltech) and New York University suggests that taking the perspective of a professional trader may alter the emotional reaction to losing money and result in different choices. Their findings appear in the latest issue of the *Proceedings of the National Academy of Sciences* (*PNAS*).

The work examined correlations between loss-averse behavior and physiological arousal while subjects were asked to either focus on individual choices or take a portfolio perspective ("think like a trader"), which was hypothesized to reduce the emotional reaction to potential losses. The researchers combined methods from psychological and economic research, providing a detailed picture of how people make choices and how their perspective changes the mechanisms of decision-making.

Specifically, they asked subjects to complete a series of 140 choices between a risky gamble and a guaranteed amount of return. Subjects completed two sets of choices—one set using a strategy emphasizing each choice in isolation and one set using a strategy emphasizing each choice as one of many. Choices in isolation are analogous to those an amateur trader might make; choices made as one of many are akin to decisions a professional trader would implement because they simulate management of a diversified portfolio.

When making choices in isolation many of the subjects were loss averse. That is, they were more concerned about avoiding financial losses than in making financial gains. However, when subjects were asked to make choices using a strategy that emphasized these choices' larger context as one of many decisions—such as the decisions one would make in managing a portfolio of investments—the vast majority of participants were less loss averse.

In an effort to examine emotional factors that may coincide with the behavioral expression of loss aversion, the researchers measured changes in subjects' skin conductance due to increased sweating in response to learning the outcomes of their decisions. The results for choices made in isolation showed that subjects sweat significantly more, per dollar, to losses than gains. This "over-arousal" to losses was correlated with behavioral loss aversion, which suggests a specific role for emotions in choice. However, when subjects made decisions using the "portfolio" strategy mentioned above, the over-arousal effect disappeared—average levels of sweating per dollar were about the same for gains and losses.

The findings could be relevant to drawing distinctions between amateur and professional traders because the professionals are trafficking in portfolios and amateurs are not. Specifically, the findings support the conclusion that professionals have learned not just facts about investments, but also strategies for limiting the normal emotional response that might prevent amateurs from making the same decisions given the same information.

The research was conducted in the laboratory of NYU's Elizabeth Phelps, one of the study's co-authors.

"These results highlight how a simple shift in perspective can influence both the emotional reaction to a financial decision, and the decision itself," commented Phelps, who is professor of psychology and neural science at NYU.

Peter Sokol-Hessner, the study's lead author, added, "Though on average we may dislike losses more than we like gains, both in our behavior and in our physiological responses to them, it seems we have the power to change that."

Co-author Colin Camerer, a Cal Tech professor of economics, added, "The role that emotions play in economic choices is not well understood. Showing that emotional reactions can be turned on 'mute' shows both that those emotions are genuine and that they can be controlled, which gives a fresh perspective on the role emotional control may play in the economy."

Source: New York University (news : web)

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