Financial Planning

PORTFOLIO

Investing Should Be Painful

By **Allan S. Roth**
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When I tell clients that pain is a strong indicator of good investing, they usually laugh. I admit it sounds like a punch line, but it also happens to be true, and my theory is backed by some strong academic research.

Further, I tell clients that, if a potential investing move feels right, that's a strong indicator to hold off. Sounds weird? Let's delve into the human mind, and then I'll apply that understanding to investing.

HOW HUMANS THINK

In the real world, risk correlates with reward. It's unusual that someone gets a large reward without taking a huge risk. Successful entrepreneurs have taken large, but smart, risks, with some reaping rewards in billions of dollars. Our minds, though, are often disconnected from reality, and we view risk and reward as disconnects.

Experiments published in 1994 by Ali Siddiq Alhakami and Paul Slovic revealed that people base their judgments of an activity or a technology not only on what they think about it, but also on how they feel about it.

If their feelings toward an activity are favorable, they are moved toward judging the risks as low and the benefits as high; if their feelings toward it are unfavorable, they tend to judge the opposite — high risk, low benefit. Of course, the pattern isn't logical, but it's how humans think. Slovic called this the affect heuristic.

RISK AS FEELINGS

In 2001, researchers led by George Lowenstein of Carnegie Mellon University proposed a new model in a paper entitled "Risk as