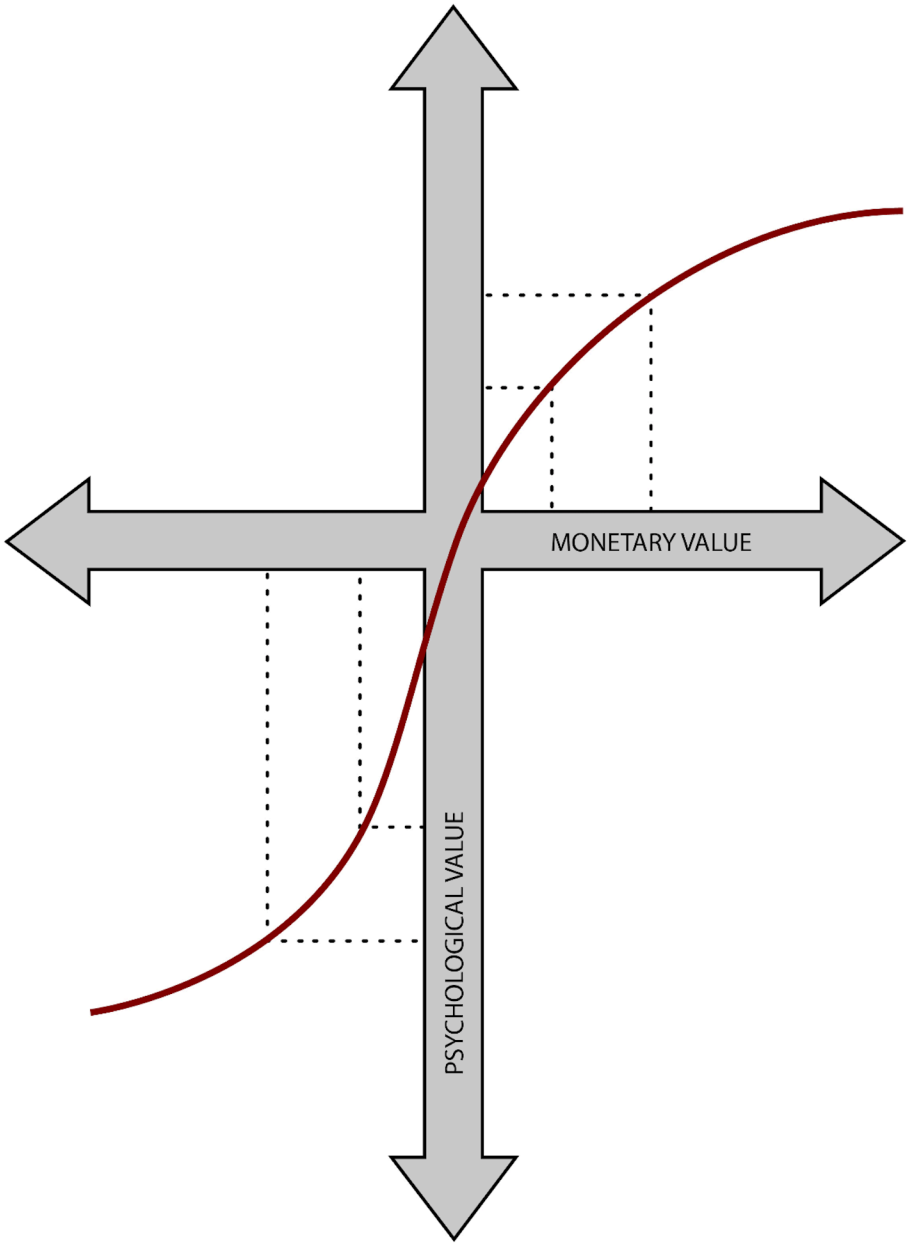

Figure 164: Prospect theory

I.2.1 People make decisions based on expected loss or gain

Faced with a choice between several outcomes without being sure which one will happen (how things are most of the time!) people make decisions based on *how much they expect to lose or gain*, rather than the outcome itself. It's a reasonable stance for your S1 to take: psychologically, you've invested more in what you own than what you don't own, so the risk of losing what you own figures prominently in your decisionmaking.

I.2.2 Value rises with sense of ownership

The s-curve shows expected losses on the left and expected gains on the right. When people form an attachment to something they own (psychological value)

its monetary value rises too. Sell a coffee mug for £1, then offer to buy it back for £2: many refuse, despite it being obvious they're giving away value. (Even more so if you write their name on it!) This simple idea—**loss aversion**—drives all trading, all marketing, all investing, and a great deal of human behaviour.

I.2.3 The s-curve is not symmetrical

Last, the graph of prospect theory shows this rise in perceived value against monetary value is *not linear*. Your fear of losing what you have *outweighs* your expectation of gaining what you don't yet have. Tell an investor to sell a falling stock and many won't, preferring to wait and see if the price rises again; parting with the stock would mean *realising* the loss. (While they hold it, the loss isn't yet "real".) Loss aversion explains most stockmarket behaviour.

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I.3 COGNITIVE BIASES AFFECT DECISIONMAKING

Being able to recognise where and when cognitive biases dominate lets you recognise them in others and in yourself. Enabling better decisionmaking in your life and work, and better sales copy on your **Letter**. Here are a few common ones, including the Big 3: **loss aversion**, the **Dunning-Kruger effect**, and **confirmation bias**.

I.3.1 Loss aversion

The best-known cognitive bias is the basis of **prospect theory**'s assymetric s-curve: people place a higher value on keeping what they already have than on gaining something they don't, even if it means losing out. Loss aversion explains all investment behaviour. Investors able to control it ride winning stocks longer and sell losing ones sooner; inexperienced investors unable to control this bias will take gains too soon and hold lossmakers too long.

I.3.2 Dunning-Kruger effect

Another big one, **Dunning-Kruger** is the tendency for those with limited knowledge or low ability to assume they're experts. (You don't know what you don't know.) It's the basis of most problems in politics and democracy: those who think they have all the answers, often know the least.

I.3.3 Confirmation bias

Confirmation bias is the tendency to seek and accept evidence that agrees with what you already know, looking for the *yes* instead of the *no*. It's why so few people can admit they're wrong. Much of today's mass media is driven by the confirmation biases of its audience.

I.3.4 Hedonic discounting

Hedonic discounting is the tendency to do what's pleasurable *now*, with an immediate payoff, rather than investing in a greater pleasure further off. It's why people find it hard to put £3 a day into a pension or insurance policy, when they never think twice about spending that on a daily coffee; natural human behaviour is to think short-term. S2 lets you think on longer timescales.

I.3.5 Anchoring

Anchoring is the tendency to rely too heavily on one piece of information when making decisions (usually the first piece of information that you acquire on that subject.) It's why people and companies stubbornly retain views and strategies that are plainly wrong: they're anchored.

I.3.6 Proximity bias

Proximity bias is the tendency to believe what's in front of your face: the parts you see, rather than the evidence that's further away or harder to understand. People naturally overweight the here and now, since what just happened features larger in their minds. It's a hard one to beat.

I.3.7 Probability neglect

Another big one. People tend to focus on apocalyptic big events with low probability, It's why the USA's lawyer culture awards huge sums for very rare events such as airline crashes and medical mishaps, but largely ignores the much larger risk of firearms at home.

I.3.8 Regression fallacy

Regression fallacies are when you think exceptional conditions, such as a rocketing stockmarket or snow in June, are the norm, and you make decisions (such as risky investing or cancelling plans for next weekend) based on those conditions. In reality, conditions regress to an average (or mean) so a better strategy is to look at the mean. Gamblers are big sufferers.

I.3.9 Framing effect

Pollsters and politicians rely on **framing effect**: a tendency for people to draw different conclusions depending how info is framed or presented. Look critically at the bias within questions of surveys and media headlines and whether information is being solicited or influenced.

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Time for an exercise.

EXERCISES: APPENDIX I

EXERCISE I.1: CHECK YOUR BIASES

Think of 3 recent decisions you had to make with incomplete information and a time limit. Which of the main cognitive biases was your decision subject to? Would you have made a different decision if you'd known a cognitive bias was driving your behaviour?

SIDEBAR:

A last word. There's a very easy way to test how susceptible you are to cognitive biases: play **poker** or take up **spread betting**. Success in both is absolutely governed by your ability to exercise logical S2 over emotional S1. And when you can, you'll have the ability to exercise some control over your animal instincts . . . and get better results from your six-figure freelancing.

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Learn to recognise where your cognitive biases affect your thinking, and when a decision you make with S1 can be better made with your S2. Think about the main biases as outlined:

- *Loss aversion*
- *The Dunning-Kruger effect*
- *Confirmation bias*
- *Hedonic discounting*
- *Anchoring*
- *Proximity bias*
- *Probability neglect*
- *Regression fallacy*
- *Framing effect*

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CHECKLIST: APPENDIX I	
DO YOU UNDERSTAND:	
Prospect Theory and the main **cognitive biases**	
HAVE YOU COMPLETED:	
2 hrs	Considered your own biased behaviour