A Strategy for Deciding When to Sell Bitcoin: Barry Ritholtz
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By Barry Ritholtz

(Bloomberg View) -- Running a money-management firm provides a window into the psyches of all kinds of people: long- term investors, real estate speculators, institutional traders, tech entrepreneurs and everyone in between. During any given week, I speak with all sorts of people who have capital at risk in markets. Most understand what they are investing in and why.

Then there are the folks who own bitcoin. Not on our recommendation, mind you; rather, through their own speculative urges and a bit of good luck. I have had conversations with folks who are now sitting on a huge financial windfall. Yet the sheer speed of bitcoin appreciation and the scale of the windfall have them paralyzed, afraid to make a decision -- any decision -- that might be wrong.

It isn't just that they don't know what to do; rather they have no idea about how to approach the issue of when to sell.

First, one thing I won't do is discuss the viability of cryptocurrencies as a medium of exchange, or their utility as a way to move money in (or out) of any closed economy or black market. I have no opinion on crypto valuations. Rather, this is simply a framework for those fortunate folks who want an answer to the issue above.

To do this, let's consider an instructive war story: during the mid-1990s, a good friend took a senior job at a tech start- up that came with a good salary -- and lots of stock. The company got taken over in late 1996 by Yahoo! Inc. The shares in the start-up were replaced with Yahoo stock options that had a six-year vesting schedule, with 25 percent vesting after three years and the balance vesting monthly during the next three- years.

For those who were trading then, these were heady times.
Tech stocks, especially the dot-coms, galloped higher, doubling and tripling over short periods. It seemed that every sale was a cause for regret, as stocks simply kept going up, up, up.

My buddy's stock options represented a great deal of wealth. Not merely fun money, but life altering: pay off the mortgage and the car loans, pay for the kid's colleges, fully fund retirement accounts and still have lots left over. He could take any job he wanted for the rest of his life -- or none at all.

He was torn about what to do, and asked for some help.

My advice was not based on the dot-com bubble or the valuation of Yahoo's stock or anything market related. Rather, I suggested employing a regret minimization framework.

Although any investment has a range of possible outcomes, I wanted to focus on potential outliers at either end of the spectrum. These were:

Scenario One: Hold and the stock tumbles from $300 to $30.

Scenario Two: Sell and the shares soar to $3,000.

How would you feel if either of these occurred?

For my friend, it was an easy decision. If he sold some of his shares and the stock went higher, he still owned a healthy slug of options. The probability of the outcome wasn't the issue; what really mattered was the potential future regret if he didn't sell and the stock collapsed.

What did happen was he sold AND the stock collapsed.
Although he was happy with his decision, not everyone at Yahoo was so fortunate. Stories abounded of paper multimillionaires and even billionaires who saw much of their wealth evaporate in the subsequent collapse.

For those bitcoin holders sitting on a windfall, they too can employ a similar regret minimization decision-making strategy. If you are holding a life-changing pile of paper gains, consider the regrets of selling and bitcoin keeps going up, or not selling and it plunges. Which is the outcome you most want to avoid?

If you are still paralyzed, there's always the middle option: sell enough -- perhaps half -- to become rich in reality and not just on paper; then let the other half ride. Doing this accomplishes several things: first, it locks in sufficient wealth to eliminate a lot of life's money-related worries.

Second, it still leaves you with upside if this is only early innings and cryptocurrencies keep rising. And, third, it protects you in case of a dotcom-like collapse (I know, that's impossible!). If this sounds a bit conventional, well, it might be, but look at it this way: the goal of life is not always to maximize your returns; sometime, potential gains must be balanced against the possibility of losses. That's why we need to occasionally consider minimizing regrets.

Regret theory traces its academic history to 1982, and was developed independently by numerous researchers, notably by Graham Loomes, Robert Sugden, David E. Bell and Peter C. Fishburn.

Note: I considered these two possibilities -- a 10-fold increase versus a 90 percent drop -- roughly symmetrical in terms of mathematics, but not probabilities (I am sure some statisticians would disagree). Both were possible, but not exactly what the analyst consensus was at the time.

This isn't about loss aversion, but regret-decision theory. In theory, investment decisions are probabilistic exercises using imperfect information about an unknowable future. But that leaves out the human side of the equation. The potential emotional response of regret when new information becomes available (e.g., price) can be a crippling experience.

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