Jay Mooreland

Behavioral Economist

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PERSONAL QUALIFICATIONS

- Bachelor of Science in Business Finance
- Master of Science in Applied Economics
- CFP® Professional
- 13+ years Professional Experience

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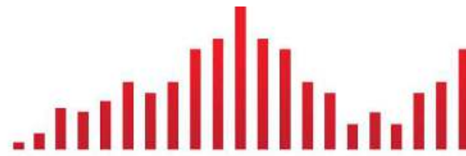

Working Effectively For Better Results.

Risk Aversion vs. Loss Aversion

Risk Aversion Defined

Risk aversion is a general preference for safety and certainty over uncertainty, and the potential for loss or pain. Most people would prefer to receive $100 guaranteed rather than a 50% chance to win $110 and a 50% to win nothing. Investors, when faced with a choice between two investments that have the same expected return, will choose the one with lower risk. Risk aversion is a quality that most people have and is widely recognized in the investment realm.

Loss Aversion Defined

Loss aversion, while it sounds like risk aversion, is actually a complex behavioral bias in which people express both risk aversion and risk seeking behavior. Loss aversion is not just the desire to reduce risk; it is an utter contempt for loss. Individuals who are loss averse feel the sting of loss *twice* as great as the joy from an equal size gain – and make investment decisions accordingly.

Loss averse investors are quick to lock in investment gains (risk averse), and hold on to their losing positions (risk seeking). Investors are 1.7 times more likely to sell a winning stock than a losing stock[1], and a study of 97,000 past trades found that selling winning stocks instead of losing stocks reduced performance by roughly 3.4% per year[2].

Investors are influenced by pride and fear to sell current winning positions, and to hold on to losers. They can feel good in knowing they realized a gain, and ride the losing positions so not to have to realize the loss. Loss aversion influences novices and investment professionals alike - experience and incentives are not a safeguard from its effects.

Neuroeconomics has found that when people are facing a loss, the amygdala in the brain begins to fire. The amygdala is our fear center. It is the amygdala that responds to mortal danger. No wonder many investors are influenced by loss aversion.

Solutions to Loss Aversion

Unlike cognitive behavioral biases, overcoming loss aversion is not as simple as recognition and a change in thinking. Because loss aversion is tied deeply to our emotions, great care must be taken when searching for a solution.

One way to reduce the influence of loss aversion is to change how the situation is being analyzed by the brain. Investment gains and losses need to be viewed as a long term marathon, and not a point in time. Investors' desire to measure investment performance using short term metrics fuels the effect of loss aversion. While most investors have long time horizons, many prefer to micromanage their performance over very short time periods.

Advisors can help investors deal live with loss aversion by constructing portfolios with less volatility and/or guaranteed investments. Advisors may want to consider portfolios with non-correlated assets and investments that offer income guarantees so they can both meet the client's financial objectives and emotional needs.

1. Montier, James, 2010. *Little Behavioral Book of Investing.* New Jersey, John Wiley & Sons
2. Zweig, Jason, 2007. *Your Money, Your Brain.* Simon & Schuster

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