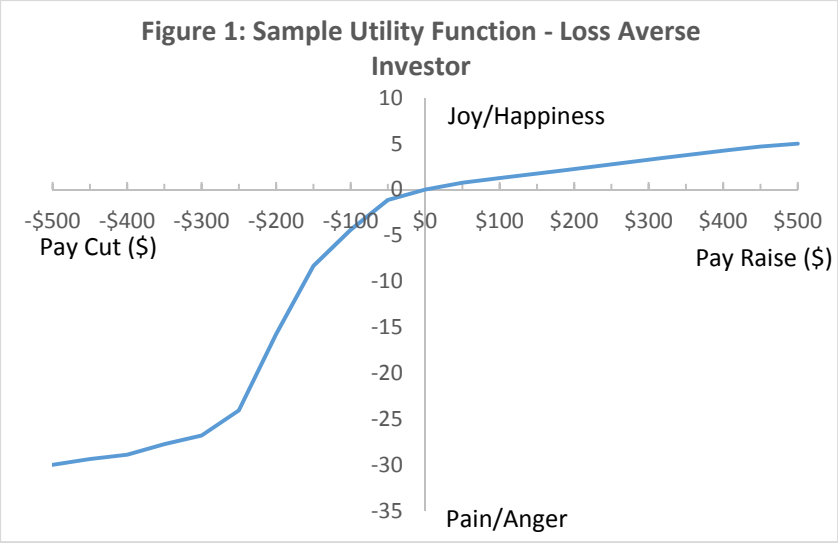
Risk Aversion vs. Loss Aversion: What is the Big Difference?

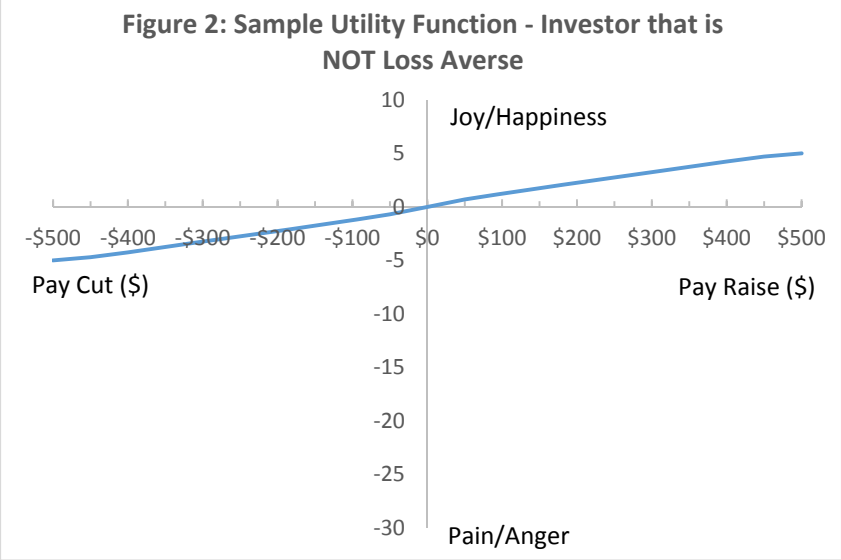
by Dr. Vicki Bogan

Most finance professionals have heard the term risk aversion and know how it affects investor preferences for risky assets. A risk averse investor will consider risky assets/portfolios only if they provide compensation for risk via a risk premium. When faced with two investments with similar expected returns (but different risks), a risk averse investor will prefer the investment with the lower risk. But what is ***loss aversion***?

To explain loss aversion, behavioral economists rely on a model developed in 1979, called prospect theory. Kahneman & Tversky's (1979) prospect theory identified loss aversion as way to explain how people assess decisions under uncertainty. An economist would describe loss aversion as the case when an individual's utility is concave over gains and convex over losses. In layman's terms, it means that a gain contributes less to utility/happiness than an equal dollar loss subtracts from utility/happiness.

Let's consider an example. Suppose you are called into your supervisor's office and he tells you that you are going to get a raise of $500 per month. How happy would you be on a scale of 1 to 10? Would you rate your happiness a 5? a 6? a7? Now consider instead that your supervisor calls you into his office and tells you that you are going to get a pay cut of $500 per month? How upset would you be on a scale of 1 to 10? Would you want to rate your anger more than a 10? For most people, the negative feelings that come from the pay cut would be much stronger than the positive feelings that would come from the pay raise. Graphically, figures 1 and 2 compare sample utility functions of a loss averse individual and a non-loss averse individual. These figures demonstrate that for loss averse individuals, the pain of the pay cut is more intense than the joy of the pay raise.





Research has repeatedly shown that loss aversion can have a strong influence on financial decisions. Genesove & Mayer (2001) show that home sellers appear to have a strong aversion to selling their homes for less than the price that they paid. Home sellers that faced a nominal loss set asking prices higher than those set by sellers not facing nominal losses. Haigh & List (2005) show that in experimental tests, professional traders from the Chicago Board of Trade (CBOT) exhibit even more loss aversion than non-professional student subjects.

Retail investors can also experience loss aversion and thus be more sensitive to losses than an investor who is not loss averse. As an advisor, it is important to recognize that while risk aversion can cause investors to shy away from buying certain types of risky assets, loss aversion can influence your clients to manage the investments in their portfolios in a sub-optimal way. For example, suppose your client is holding onto a stock that has declined significantly in value since the time it was purchased. You may recommend selling the stock. However, since selling the stock would mean realizing a loss, the client may be resistant to doing so, despite your professional assessment and recommendation. This reticence has nothing to do with your client's lack of trust in you but everything to do with loss aversion. Selling the stock may be in the best interest of your client but it would force him/her to feel the loss. This feeling of loss can be strong enough to cause your client to keep a poor performing stock. Separating the decision from the feeling of loss is essential for the client to make a sound financial decision.

So what should you do as an advisor? Utilizing a behavioral economics nudge may be effective in this type of situation. *Reframing* the decision as one that could lessen a loss or has the opportunity to generate a gain, may help to ameliorate the client's loss aversion. Explaining that it is best to sell because the stock may continue to fall in value or that selling the stock will free up some cash that could be used for a better investment may be helpful. Additionally, pointing out the potential tax benefits of realizing the investment loss may be useful in reframing the decision as one that could generate a potential gain.

Key Take-Aways

- Risk aversion and loss aversion are different and have different influences on client financial decisions.
- It is import to get a client to separate a financial decision that will incur a loss from the *feeling* of loss.
- Reframing an investment decision in a way such the client does not view it as a loss (tax benefit, opportunity for a different investment, etc.) could be helpful in enabling the client to overcome loss aversion.

References

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