Reason in action

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Investment Solutions

Trust must be earned

Don't let your habits hold you back, start making choices that help your financial future

In collaboration with the Amundi Investment Institute.

The fear factor: loss aversion in investing

"Losses weigh more heavily than gains."

Daniel Kahneman, 2022 winner of the Nobel Memorial Prize in Economics

What is loss aversion?

- Loss aversion refers to the phenomenon where the negative feelings caused by a loss are more intense than the pleasure experienced from gaining an equivalent amount.[1] For example, the disappointment felt when losing €100 is stronger than the satisfaction of winning the same amount. Studies estimate that **the negative emotional impact** associated with a **loss** or a **sacrifice** is **twice as powerful** as the **satisfaction** felt when an **equivalent gain is made**.[2]
- This stems from **survival mechanisms** where, situations perceived as **negative** and therefore potentially **dangerous** demand **more urgent attention**.[3]

Examples of loss aversion

- **Workplace benefits:** when a company removes free coffee machines, employees' complaints about losing the perk are far stronger than their initial appreciation when the machines were introduced. The **removal**, is perceived as a **loss**, often triggering a **more intense emotional response** than the positive reaction to the **original gain**.
- **Reluctance to leave a social circle:** even if they don't thrive in a social circle (friends, colleagues, members of a club etc.), some people are hesitant to leave out of fear of losing valuable relationships, opportunities or information. The **fear of losing what they have,** despite limited satisfaction, **can often outweigh the potential benefits** of leaving.

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How loss aversion can affect investment decisions

- **Overcaution:** Investors may keep their savings in **low-yield savings accounts** rather than investing in **financial markets**. This behaviour is often driven by a fear of loss, stemming from an **exaggerated perception of market risks**, especially when they **focus on the short-term performance** of their portfolio.[4]

- **Impulsive decisions:** When **the value of their shares fall**, such as during a market downturn, investors may **panic** and fear **further losses**. As a result, they may rush **to sell their shares**.[5]

Time for action: overcome loss aversion in your financial decisions

Recognising the impact of loss aversion is the first step towards making better financial decisions.

Ask yourself these questions:

- ☐ Have I avoided investing in risky financial assets (such as shares)?
  - **Take a long-term view:** the probability of incurring a loss is statistically lower over the long term.
  - **Diversify* your investments** to limit risk and minimise the emotional impact if some of your investments decline in value.
- ☐ Did I sell a declining investment in a panic?
  - Next time, **avoid making impulsive decisions:** take the time to assess the situation and consult a financial adviser if necessary.

**Diversification does not guarantee profit or protect against a loss.*

Investing involves risk.

SOURCES

1. Kahneman, Daniel, and Amos Tversky. (2013) *Prospect theory: An analysis of decision under risk*
2. Kahneman, Daniel, Jack L. Knetsch, and Richard H. Thaler (1990) *Experimental tests of the endowment effect and the Coase theorem*
3. Baumeister, Roy F., et al. (2001) *Bad is stronger than good*
4. The effect, known as myopic loss aversion, occurs when investors focus heavily on the short-term performance of their investments, causing them to overreact to short-term losses and potentially overlook long-term gains. As a result, a myopic investor suffering from loss aversion is likely to adopt a lower level of risk. Thaler, Richard H., Amos Tversky, Daniel Kahneman, and Alan Schwartz (1997) The Effect of Myopia and Loss Aversion on Risk Taking: An Experimental Test
5. Barberis, Nicholas, and Ming Huang (2001) Mental accounting, loss aversion, and individual stock returns

IMPORTANT INFORMATION

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