INVESTMENT INSIGHT

BY: DHRUV BHATIA

I hate losing > than I love winning

What is Risk?

Risk is the possibility that the investment's actual return will differ from the expected return. Risk includes the possibility of losing some or all of the original investment, which is also termed as permanent loss of capital.

Investors often confuse themselves between being risk averse and loss averse. Risk aversion and loss aversion are different and have different influences.

A risk-averse investor is one who will consider a risky investment only if it provides a return for the risk to be taken. Given an opportunity to make a certain gain as opposed to uncertain ones a risk-averse investor would prefer the certainty. Let’s consider an example of 2 investments that are giving similar returns say 10% p.a. but one is more riskier than the other then, a risk-averse investor would prefer the investment with lower risk.

On the other hand, a loss-averse investor prefers avoiding losses rather than accruing gains. In this regard, Daniel Kahneman and Amos Tversky developed the Prospect Theory in the year 1979 under the assumption that losses have 2-2.5 times larger impact on an investor’s preference rather than making gains. It means that investor values losses higher than gains i.e. losses are more painful than an equal gain.

Risk-averse investors are typically hesitant to invest in risky assets, while loss-averse investors manage their investments sub optimally, i.e. in the event of a loss, an investor might prefer to take more risks to try and make up the loss by buying more, commonly termed as doubling down of the position. Such Investors hate losing money, which sometimes leads them to take on more risk.

We can look at the below examples to understand this theory in detail:
Let's assume you purchased a stock recommended by an expert but the value has declined significantly since the time it was purchased. The expert recommends you to sell the stock and book a loss. However, since selling the stock would mean realizing a loss, you may be resistant to do so despite being recommended. Selling the stock may be for the good but you feel the pinch of incurring the loss. This feeling of loss can be strong enough to make you hold on to a poor-performing stock. This relates to selling winners early and hanging on to losing positions, as you can't bear to take the hit of a loss. For making a sound decision it is important to separate the emotions occurring due to a loss and making rational decisions.

Amos Tversky and Daniel Kahneman performed an experiment, which gives us a clear example of a human's bias towards losses. The experiment involved asking people if they would accept a bet based on the flip of a coin. The condition being if the coin came up tails the person would lose $100, and if it came up heads they would win $200. The results of the experiment showed that on average people needed to gain about twice (1.5x – 2.5x) as much as they were willing to lose in order to proceed forward with the bet (meaning the potential gain must be at least twice as much as the potential loss).

It is believed by many investors that a loss isn't a loss unless it is realized. Such investors often want to hold on to their losing stocks and sell their winning ones when they should actually be doing the opposite.

Investment gains and losses need to be viewed as a marathon, and not a sprint. While most investors have long time prospects, many prefer to minutely manage their performance to a very short time period.

We now know that a bias does exist and how it affects our investing decisions. However, we cannot fully eliminate loss aversion, but we can definitely be aware of it.

About the Author:

Dhruv Bhatia, Research Analyst

Dhruv Bhatia is Research Analyst with BOI AXA Mutual Fund. Dhruv joined BOI AXA in November 2018, and has more than six years of experience in Equity Research analytics. He has been associated with organizations such as AUM Fund Advisors, Sahara Mutual Fund, over the span of his career. His qualifications include Bachelors of Management studies from MMK College of Commerce & Economics (2009) and further pursued his PGDM (Finance) from SIES College of Management Studies (2012). He has also successfully cleared Level 1 of CFA. Addition to that he is accredited with NSE's Certification under Financial, Capital & Derivative Market.

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