Fundamentals of behavioral finance: Loss aversion bias

Why clients value avoiding losses more than winning gains

Key takeaways

- Loss aversion drives people to prioritize avoiding losses over earning gains.
- Behavioral scientists have found that the pain of a loss is felt more strongly than the pleasure of an equivalent gain.
- Loss aversion can lead to portfolios that are too conservative.
- This conservative tilt may not give clients the growth potential they need.
- By teaching clients about loss aversion, advisors can more easily steer them toward more rational investment decisions.

In this series, we explore some of the most common biases exhibited by investors, and discuss how advisors can help their clients overcome them. This article focuses on **loss aversion bias**, an emotional bias that can derail investors from their long-term goals.

What is loss aversion bias?

Loss aversion is the tendency to avoid losses over achieving equivalent gains. Broadly speaking, people feel pain from losses much more acutely than they feel pleasure from gains of the same size. Loss aversion bias typically shows up in financial decisions: people often need an extra—and sometimes significant—incentive to take financial risks that might result in a loss.

Nobel Prize-winning economist Daniel Kahneman illustrated how this plays out in a simple experiment he conducted with his students: he told them that if a flipped coin lands on tails, they'd lose $10. Then he asked them how much they would need to win to make the coin flip worth the risk of losing $10. The answer, he said, was typically more than $20.

Why does it matter?

Loss aversion can result in clients avoiding risk, leading to overly conservative portfolios that don't deliver the returns they need to achieve their goals. It can also push clients to sell during a stock market downturn simply to avoid further losses—which could mean they miss out on gains when the stocks they've sold rebound.

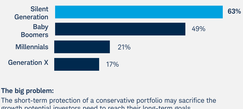
Conversely, loss aversion can lead clients to hold on to investments that have declined in value to avoid realizing a loss in their portfolio, even when selling is the prudent decision.

Loss aversion is a major reason why so many investors underperform the market. For example, in 2018, a year that saw two sizable market corrections, the average investor lost twice as much as the S&P 500® Index, according to the financial research company DALBAR.[1] This disparity can largely be attributed to investors selling stocks out of fear of further losses, and consequently missing out on market rebounds.

At a glance: Loss aversion bias

Head or Heart?
Loss aversion is an emotional bias. It describes the tendency to prioritize avoiding losses over earning gains.

Who has loss aversion bias?
Advisors say...*



The big problem:
The short-term protection of a conservative portfolio may sacrifice the growth potential investors need to reach their long-term goals.

How Advisors can help:
Advisors can educate investors about how markets move over time.

* Ceruli Associates, "BeFi Barometer 2020." Survey, July 2020.
** Charles Schwab Investment Management; S&P 500® Index for stocks; Bloomberg Barclays US Aggregate Bond Index for bonds; monthly rebalancing.

What can you do about it?

Loss aversion is rooted in a deep-seated instinctual impulse to avoid pain. Making decisions before market volatility has a chance to play on clients' emotions can help keep them from making emotionally charged decisions. Work with your clients to set up guidelines and objective rules for buying, selling, and rebalancing, particularly when facing difficult market conditions that require a more systematic approach. For example, agree that you won't sell a holding unless it falls by a certain percentage.

Additionally, consider suggesting to clients with an especially strong emotional bias to go on a media diet. The financial media tends to focus on dramatic short-term ups and downs in the market rather than longer-term performance trends. Staying clear of the financial news can help keep clients from experiencing the fear that leads them to make harmful short-term decisions.

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Overconfidence bias | Loss aversion bias | Recency bias

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[1] "Quantitative Analysis of Investor Behavior, 2019," DALBAR, Inc. www.dalbar.com.

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The 2020 BeFi Barometer surveys approximately 300 financial advisors to learn how advisors view and use behavioral finance when working with clients. Conducted by Ceruli Associates in May and June 2020. Respondents were members of the Investments & Wealth Institute® and diversified among business models, including wirehouse, registered investment advisor (RIA), and national/regional broker dealers. All data is self-reported by survey participants and is not verified or validated.

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Rebalancing, diversification, and asset allocation cannot ensure a profit, do not protect against losses, or guarantee that an investor's goal will be met.

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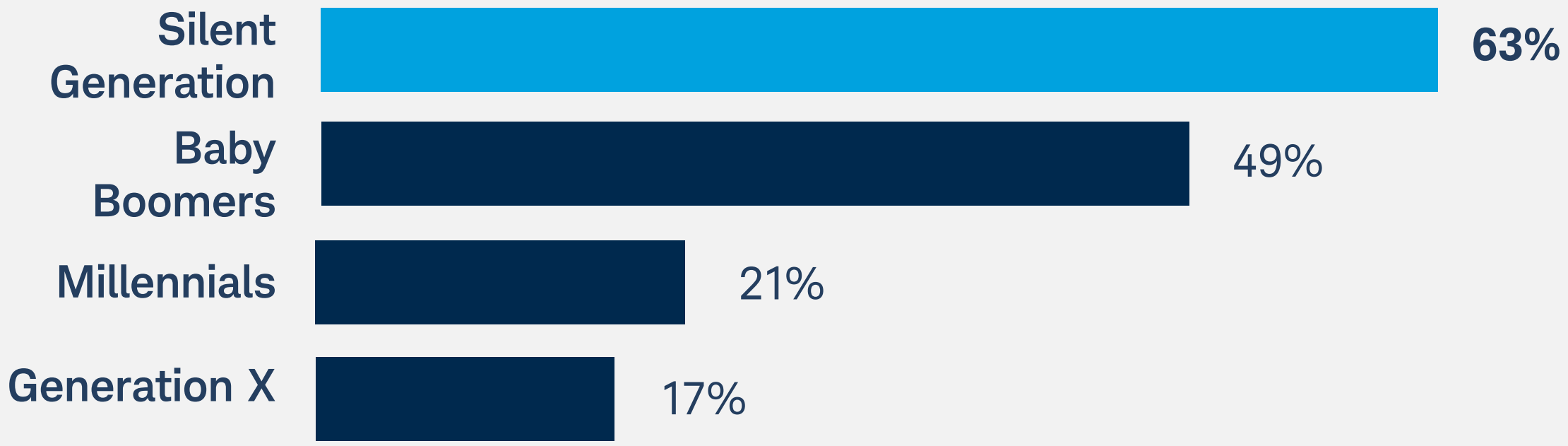

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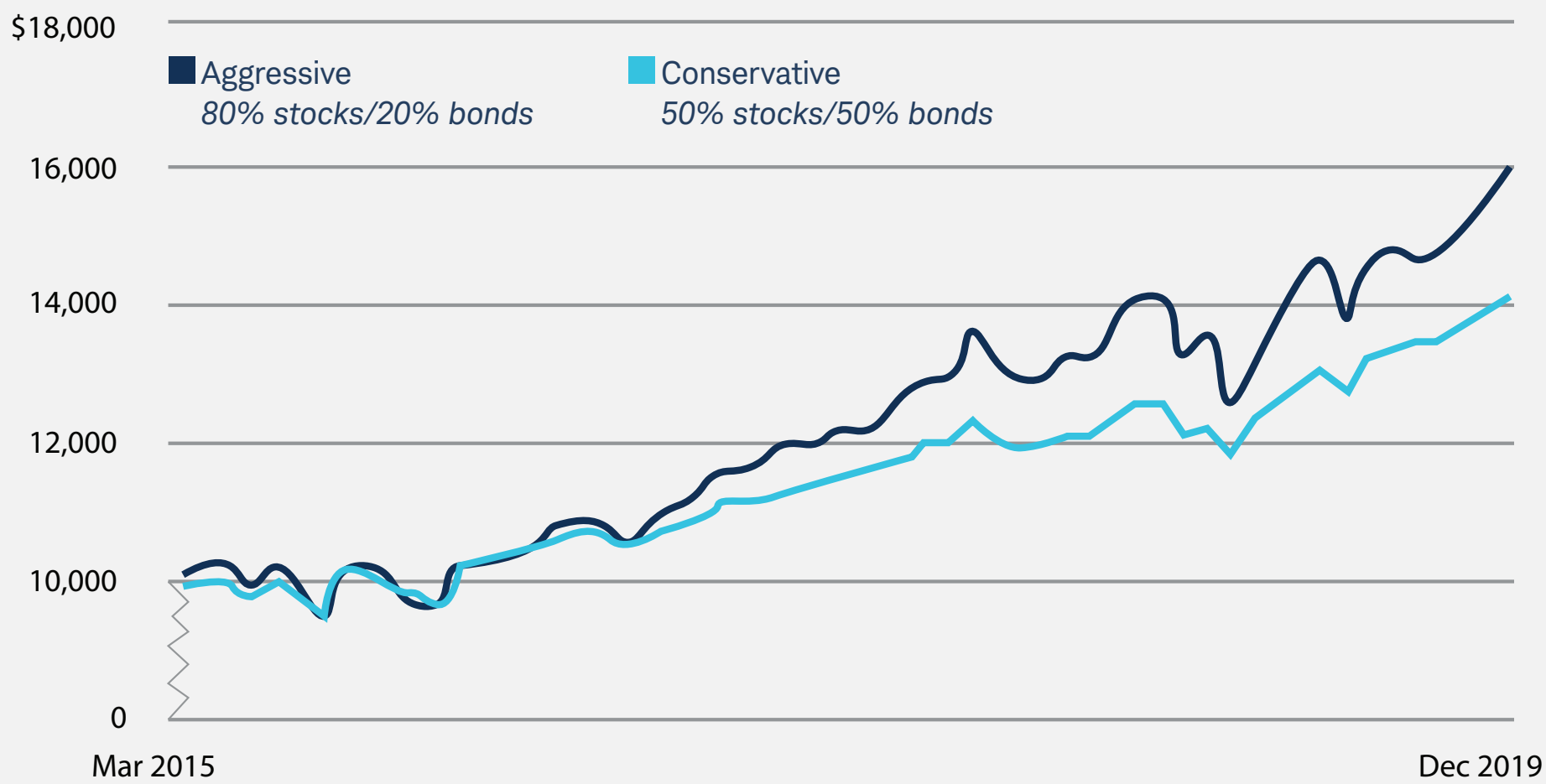
Long-term growth of $10,000**



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