When Averting Loss Can Lead to Averting Gains

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Think about something you'd really hate to lose, something of value to you such as a treasured possession. Now imagine you're told that if you lay that object on the line in a bet, you have a good shot at doubling its value, but there's also a possibility you'll lose it. How low would the chance of loss have to be before you'd be willing to take the risk? Maybe 10%? Less than that? The answer may lie in a behavioral economic theory called "loss aversion."

Now imagine it's your dream of retirement and the money required to reach that dream that is on the line. How low does the risk have to be then for you to be willing to take it? Muddying the waters further: how does your thinking change if you've just lost that favored possession? No one likes to experience loss; as humans, we often find it painful. So painful that the prospect of experiencing the pain of loss can paralyze us from taking another risk, even when it's potentially small or when the rewards of taking the risk are potentially great. In a volatile and uncertain market and economic environment like we've been in since the 2008-2009 financial market crisis, there's a strong chance that any given investor has recently experienced some type of loss.

Dan Ariely, James B. Duke Professor of Psychology and Behavioral Economics at Duke University, has extensively studied humans' often irrational behaviors and actions, including the concept of "loss aversion." He shared some insights with us about his experiments and findings about how we experience the pain of loss, and how it often overrides the reward felt from gain.

"People hate losing much more than they enjoy winning. How happy are investors when they make 3% on their investments and how miserable are they when they lose 3%? There is a tremendous asymmetry."

It's certainly understandable for investors to make financial decisions based on a desire to avoid the pain of loss, but that may not always be productive for portfolios in the long term.

Is Loss Aversion Actually Encouraging Loss?

Fear of loss can cause investors to not only miss out on opportunities, but take emotional actions—such as liquidating their assets—that could run counter to their long-term investment goals. Fear plays a big part in market psychology, and it can be a powerful force!

Ariely authored *The New York Times* bestseller, “Predictably Irrational: The Hidden Forces That Shape our Decisions.” In it, he provides an example of just how people not only fear loss, but actually mourn it before it even occurs.

”People just hate giving money back, and because of this, they do things that are financially inefficient,” he says. “Do you wonder why we often refuse to sell some of our favorite clutter, and if somebody offers to buy it, we attach an exorbitant price tag to it? As soon as we begin thinking about giving up our valued possessions, we are already mourning the loss.”

This applies not only to clutter taking up space in our attics, but to investments taking up space in our portfolios—investments that may no longer be working for us.

Let’s explore the impact of an investor’s decision to try avoiding an investment loss by moving and holding assets in vehicles they perceive to be “safe,” such as money market accounts, CDs or 10-year Treasury notes. As of June 30, 2012, if you had invested $10,000 in a money market for one year, you would have earned about $4, perhaps enough for a latte at your favorite coffee shop.[1]

A 1-year CD would earn around $21—enough for two tickets to a movie (not including popcorn or drinks).

And if you’re thinking a 10-year Treasury is much better, guess again. Earning approximately $162 over that same one-year time period, that might be enough to buy a week’s worth of groceries. And, not to get too bleak, but when you factor in inflation and taxes, these meager yields could look even worse.[1]

The Price of Perceived “Safety”

What many investors perceive as “safety” can come at a cost: loss of potential return. You can imagine how the desire to try and avoid market losses often causes investors to move their money out of stocks and into cash or fixed income vehicles, but rather than avoiding losses, they often wind up trading potential market losses for potential negative real returns, especially once the impact of inflation is factored in.

What does this shift into low-yielding instruments mean for investors? It means their investments are essentially at a standstill, while their investment goals—buying a home, college, retirement, and so on—probably continue to require some sort of capital appreciation.

It appears that for the short term, many investors have been opting for safety. However, it’s important to not lose sight of the long term. When the Franklin Templeton 2012 Global Investor Sentiment Survey[2] asked participants what they believed would be the best asset class over the next 10 years, the number one response was “equities.” It would seem many investors recognize that today’s uncertainty won’t likely last forever. The question is whether they’re ready to take the risk.

So how do you overcome the emotional reaction of loss aversion? Having a defined asset allocation plan, and engaging in regular portfolio rebalancing can help. Working with an advisor to gain some rational perspective can help, too.

Curious about behavioral economics? Read more in our recent post on the concept of Availability Bias, “When Do You Ignore Your Gut?”

Want to learn more about how to overcome your fear of loss in the markets and make less emotionally driven decisions? Visit our new 2020 Vision: Time to Take Stock website.

Get more insights from Franklin Templeton delivered to your inbox. Subscribe to our Beyond Bulls & Bears blog.

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Important Legal Information

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Sources: Money Market Accounts and 1-year CDs: BanxQuote; 10-year Treasuries: The Federal Reserve H.15 Report. Copyright © 2012 BanxCorp. All Rights Reserved. BanxQuote® is a registered trademark and servicemark of BanxCorp.

Calculation based on average yields as of 6/30/2012.

2. Source: 2010 Franklin Templeton Global Investor Sentiment Survey designed in partnership with ORC International included 1,000 telephone responses from participants age 18 and older in the U.S. from March 24, 2010 to March 26, 2010; 2011 Franklin Templeton Global Investor Sentiment Survey designed in partnership with ORC International included 1,049 responses from participants age 18 and older in the U.S. from January 6, 2011 to January 7, 2011; 2012 Franklin Templeton Investor Sentiment Survey designed in partnership with Duke University professor Dan Ariely and Qualtics included 1,142 online responses from participants age 18 or older in the U.S. from January 30, 2012 to February 13, 2012.