PENNY WISE

PARAG PARIKH

How the wish to avoid loss can lead one to take more risks and become reckless

IF IT WERE true that investors are risk averse, the stock markets would be deserted places. The truth is, investors are not risk averse but loss averse. Evidence suggests that the pain of a loss is three times more than the pleasure of an equal amount of gain. Say you get an electric shock from a damaged light switch. The pain and fright will dissuade you from touching the switch until it is repaired. The memory of that painful experience is scary, and it lingers. Now, say you acquired a new two-wheeler. You were delighted when you bought it. But the pleasure doesn't last quite as long. Pretty soon, you're wishing you had a car.

Pain over time becomes terrifying, and pleasure becomes boring. That is why we suffer from the behavioral anomalies of "Loss aversion" and "Aversion to a sure loss". Loss aversion makes us avoid risk and flee to safety. But aversion to a sure loss is what makes us take *more* risks and become reckless. In the world of finance, these anomalies play an important role in decision-making.

Loss aversion is the reason we choose fixed income over stocks. After the tech bust, investors avoided equities and chose bank deposits and liquid funds. In 2003, the equity markets were at a low, and there were good opportunities everywhere. Loss aversion created great opportunities for those who understood such behaviour.

TOPSY TURVY

"It makes sense to ride the winners and sell the losers, but loss aversion makes people do the exact opposite"

Why do most portfolios have a few winners but a long list of losers? Why are your profits from your winners smaller than your losses from your losers? Due to loss aversion, investors sell their winners fast and hold on to the losers. Investors behave as if the loss occurs when the sale is made, when in fact the loss has alreadyoccurred, with the depreciation in price. Offsetting a loss against other income has tax benefits, too—it makes good sense to ride the winners and sell the losers. But loss aversion makes people do the exact opposite.

Aversion to a sure loss leads us to throw good money after bad money. How many times have you heard this argument: "The stock is down, so I'll buy more, to bring down my average purchase price. I know the stock will go up."

Aversion to a sure loss, also known as the "Sunk Cost Fallacy", makes investors average the cost of purchase. Our ego clings to our original commitment, and we go to great lengths to justify the same. To be sure, if you have identified a great stock, you should accumulate it when it's cheap. But the focus should be on buying a great stock at a low price, not solely to lower the average purchasing cost.

Expensive repairs on ageing assets are another example of aversion to a sure loss. Sometimes, it's cheaper to replace the assets. Casinos do roaring business due to this human behavior because losing customers tend to take more risks and increase their bets. So is the case with traders speculating in futures and options.

Here are some tips to overcome the above anomalies. Check your threshold for taking a loss and keep within those limits. Invest across assets rather than concentrating on a single asset. Look at your portfolio performance as a whole, rather than individual asset classes. Reframe losses as gains considering the tax advantage you get. When you speculate, keep one eye on your loss-taking capacity.

The writer is chairman, Parag Parikh Financial Advisory Services and specialises in behavioural finance. He writes every second week of the month on behavioural finance