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An aversion to losses is only natural

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As investors, we do not like to lose money. In fact, academic studies show that the pain of losing money is psychologically about twice as strong as the pleasure of making a profit.

Consider the following two options:

Option 1: A guaranteed return of £10,000.

Option 2: Playing the Euromillions lottery with an 80% chance of winning £12,500 and a 20% chance of winning nothing.

If you are like most people, you will prefer option 1. From a purely rational perspective, the two options have an almost identical expected gain, but option 2 is inherently riskier. And this additional risk tends to drive most people toward option A. The chance of winning an extra £2,500 compared to the safe option is not worth the risk of winning nothing. This is an example of risk aversion, and it means that investors are only willing to take on additional risk if they feel they are adequately compensated for it (in the form of higher returns).

Now consider that you have to choose one of these two options:

Option 1: A guaranteed loss of £10,000.

Option 2: Playing the Euromillions lottery with an 80% chance of losing £12,500 and a 20% chance of losing nothing.

In this scenario, most investors will prefer option 2. However, a risk averse investor should actually choose option 1 over option 2 as this carries greater risk whilst offering the same expected return.

Interestingly, by switching the above scenarios from a potential gain to a potential loss, most investors switch from being risk averse to being risk takers. This concept is called loss aversion and is a very important factor to understand when investing for the longer term.

Loss aversion can be described as a natural tendency to avoid losses whenever possible. Instead of accepting a loss, we try to avoid it if possible, even if this means risking an even bigger loss. Numerous studies carried out over the years, as well as analysis of real life investment decisions, have shown that losses are perceived (by investors) to be about one and a half to three times worse than similar gains. In other words, gains have to be one and a half to three times higher than potential losses before an investor accepts a risky investment.

Understanding an investment's return profile is vital to managing potential losses. When assets are expensive, the payoff profile for an investment alters to not provide the same upside potential whilst increasing the chances of a loss. For us, limiting losses is a vital component when trying to generate strong 'real' long term returns.

This is one of the key tenets of the Tacit process and ultimately drives us to being nervous investors when asset prices have risen and more optimistic after they have fallen. This is not a science and requires substantial analysis to understand what the future may hold. Valuations are where we focus our attention as history shows owning too much of an expensive asset might make you happy in the short term but normally lead to poor outcomes in the medium to long term.

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