*I hate to lose more, than I love to win.*

*-Jimmy Connors*

Perhaps the backbone of behavioral finance, loss aversion is inevitable. It's a psychological phenomenon so deeply engrained in our core, that loss aversion transcends economics and can be found in micro and macro decisions made by people everyday. Jimmy Connors (former No. 1 tennis pro) said it best, and so many athletes and ultra competitive individuals have adopted the mentality, "I hate losing, more than I love to win." That's a big difference. Loss aversion triggers one of the most animalistic instincts we have- flight or fight. If you hate to lose more than you love to win, perhaps you're willing to do anything *to not lose (read: survive)*. You might become risk seeking in your decision making process. Make no mistake, risk seeking behavior is still often times guided by fear. For others, you might become paralyzed by this loss aversion, opening the door for the inertia effect to grab hold of you. Understanding what powers are at play in our decision making process is equally as important as the decisions themselves. It's the fine line between what decision *should be made,* and what decision is *actually made.*

**Flip A Coin**

A little over 40 years ago, two psychologists labeled what is known today as loss aversion. Daniel Kahneman and Amos Tversky's work exploded into the mainstream roughly 30 years after their initial collaboration through Kahneman's book "Thinking Fast and Slow". The work these two collaborated on earned Kahneman a Nobel Prize (it was awarded 6 years after Tversky died in 1996), and something of a celebrity status among those of us who are captivated by people's decision making processes.

In investing, people are making decisions everyday, all day long, all over the world. Often times with significant stakes on the line. Believe it or not, most of those decisions are likely not being taken with a process that's data driven, and rational. No, that's because humans are irrational and driven by gut instinct more times than not. Intuition receives a lot of credit from us when we try to explain away how we "knew" we'd be right. I know another author who taught us that we should probably be crediting randomness more often than our intuition, but I digress.

The lack of rationality in these daily investment decisions is something that Kahneman's work around Prospect Theory tries to expose. Prospect Theory cites the individual's tendency to view losses in a more extreme light than we do wins. Like Jimmy said, we hate to lose more than we love to win. In fact, professor Kahneman's work has shown that we typically hate to lose *twice* as much as we like to win.

This theory can be boiled down (at the risk of oversimplifying) to a simple exercise of picking between the heads or tails sides of a coin. Professor Kahneman would often times ask his students, or those participating in his studies, if he were to flip a coin and it landed on tails resulting in the participant losing $10, how much would they have to win on a heads result in order for them to participate? The average answer he found in his work was $20.

Prospect Theory also acknowledges that it's important for one to conduct a decision making (risk assessment) exercise with stakes that are representative to their own lives. For some, a hypothetical loss of

$10 might mean more or less than to others. In wealth management, it's also important to include a bit of context behind what the monies being invested are intended to achieve.

Take this question below as an illustration of how we can combine Prospect Theory with discovering our risk profiles:

You have $1 Million dollars to invest and you have two investment opportunities in front of you. The first option gives a 100% certain return of $1 Million dollars. The second option provides a 50% chance at returning $50 Million dollars, or a 50% chance of losing your initial $1 Million. Which do you choose?

To everyone else who suffered from test anxiety their whole life like me, don't worry, there is no right answer here.

The math says the second option carries the higher expected value (a 50% chance of $50M carries a $25M expected value). For so many of us, a 50% chance of losing our principal investment is too daunting. Then again, if you hate losing, you'll really hate losing $1M dollars.

**Risk is Personal**

We've found that introducing a goals-based investment mindset into this process helps reduce the desire for lottery winning style results may approach markets with.

Risk is a highly subjective concept. Risk tolerance, risk capacity, risk perception all fluctuate from person to person. Working through these risk assessment exercises during the planning stages of the portfolio construction process helps investors limit the amount of "gut" decisions they take when it comes to allocate capital, as well as deepen their understanding of their own loss and risk aversion.

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