

For customers

# What makes an investor tick?

The decisions we make in life aren't always rational – emotions can play a big part too. And investment decisions are no exception.

## What is risk aversion?

Have a think about the following question.

Imagine you're on Deal or no deal, and it's crunch time. There are only two boxes left: one has 1p in it and the other has £250,000. The Banker calls and offers you £130,000.

Do you 'deal' and take the £130,000?

Or do you say 'no deal' and potentially walk away with £250,000 – bearing in mind you could just as easily walk away with 1p?

The decision is yours.

The programme-makers anticipate that most people will go for the £130,000. This theory is known as **risk aversion**: taking a smaller amount but with a more predictable outcome. It's particularly common when dealing with large sums of money.

Risk aversion is nothing new. But our understanding of it changed in the late 1970s, following a study by Israeli psychologists Daniel Kahneman and Amos Tversky. They asked participants the following two questions:

### Question one

You have the choice:

- (a) take £300,000, or
- (b) gamble, giving you an 80% chance of winning £400,000 and a 20% chance of winning nothing

### What would you do?

### Question two

You have the choice of:

- (a) losing £300,000, or
- (b) gambling, giving you an 80% chance of losing £400,000 and a 20% chance of losing nothing

## What would you do?

In response to question one, 80% of people surveyed said they'd take the guaranteed sum. This is what we'd expect based on the theory of risk aversion.

In question two, the choice is between taking a guaranteed loss or gambling with an 80% chance of losing more money and only a 20% chance of not losing anything. Based on the theory of risk aversion, we'd expect few would want to take that risk. In fact, 92% of people in the study said they'd gamble.

This is because our decision depends on whether we're in profit or loss at the time. Kahneman and Tversky found that we're 'loss averse': we don't like to lose money, so when we're faced with a loss, we're prepared to take a risk.

## Loss aversion

The term 'loss aversion' refers to our preference for avoiding losses rather than acquiring gains. In other words, we tend to go for the safe option. In investment terms, loss aversion means that investors are more likely to sell investments that have performed well and take the profits, even when they expect the value to keep rising. They're also likely to hold onto investments that haven't done so well.

## Risk profile

Thinking about risk aversion and loss aversion shouldn't put you off investing. But it's important to understand your own tolerance for risk. That's why many financial advisers now use risk profiling tools to determine how much risk you're willing to take.

Depending on which tool they've used, your adviser will ask you certain questions about investing. Many of these ask how strongly you agree or disagree with a particular statement, while in others you can choose a more specific answer from a selection.

**For example:**

1. Reaching my target is very important to me – I'm willing to save more and accept potentially lower investment returns in order to achieve it.
2. It doesn't matter if my investment temporarily falls in value: achieving high expected long-term investment returns is more important to me.
3. Where have you decided to invest in the last five years?
  - Mainly cash and savings
  - Mainly bonds
  - Mainly shares and bonds
  - Mainly shares
  - Mainly property (other than your main residence)
  - A combination of these investments
4. You invest £10,000 in a share. The following day it drops 10% in value. You:
  - put in a further £10,000 while it's down.
  - sit tight because you did the research.
  - are concerned, but keep it.
  - wait for the stock to regain the £1,000 loss, then sell it.
  - sell and go back to a deposit account.
5. I usually feel concerned or worried after making a financial decision.
6. What sort of risk-taker would your friends describe you as?
  - Adventurous
  - Willing to take risks after research
  - Cautious
  - Risk-averse
  - Afraid of your own shadow
7. Realising that there will be occasional downturns in the market, how long a recovery period are you prepared to wait?
  - Less than six months.
  - Six months to one year.
  - One to two years.
  - Two to three years.
  - Three to five years.
  - More than five years.
8. When making an important investment decision, what's your main consideration?
  - I worry I may lose money.
  - I consider the potential loss as I don't want to risk too much of my capital.
  - I aim to balance the risks I'm taking with the rewards I expect.
  - I consider the potential gain first and I'm willing to take some risks to see higher returns.
  - I expect to make a gain, and I'm willing to take risks to do this.
9. I want to play an important and active role in managing my investments.
10. For many investors, the possibility of loss is more significant than the possibility of making a corresponding profit. How does this reflect your own view?
11. I enjoy the feeling of 'thrill' associated with gambling.
12. How important do you rank potential growth compared to security for this investment?
  - I'm willing to take significant risk in order to maximise the potential growth of capital.
  - Growth potential is important, with security as a secondary consideration.
  - As far as possible, I want to balance potential growth with security.
  - Security is important, with growth potential as a secondary consideration.
  - I want to avoid losing money, at all cost.

These are just examples of the types of questions a risk-profiling tool might ask. They show how these tools come up with your risk profile based on your investment goals. This will help you and your adviser decide what type of investment is right for you.

[Speak to your adviser today to find out your risk profile.](#)