

For customers

What type of investor are you?

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. I would be willing to risk a percentage of my income in order to get a good return on an investment.
2. I have been extremely cautious in my past financial investments.
3. Even if I experienced a substantial loss on an investment, I would not be put off making risky investments.
4. I believe that it is reckless to take financial risks.
5. When I'm faced with a financial decision I am generally more concerned about the possible losses than the probable gains.
6. I would rather know that I was getting a guaranteed rate of return than be uncertain about my investments.
7. If my investment portfolio dropped significantly in value during the first three months, it would not bother me.
8. I would never take a chance with any amount of money.
9. I believe that the only way to make money is to take financial risks.
10. Taking financial risks is important to me.
11. I would be happy investing a large proportion of my income in a high-risk investment.
12. How comfortable do you feel when you take a financial risk?

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.

The value of investments can fall as well as rise and you may not get back the amount you originally invested.

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