# Term of the Week- Loss Aversion Theory

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Loss aversion theory, also known as prospect theory, states that we put a greater emphasis on perceived losses relative to perceived gains. In other words, we tend to feel twice as bad when we lose as when we gain an equivalent value.

Investors balance the risk and reward of an investment decision before making it, but because our brains are hardwired to focus on the negative (avoiding harm) we place more emphasis on the potential for loss than the prospect of making a gain.

The implications of this are that investors can often sell a losing position early, even though the fundamentals point to it being a short term drop from which the value should recover. This can exaggerate sell-offs in markets.

The theory also states that we place a very low importance on events which have a low probability of occurring, such as “black swan” events in markets. The bias in our thinking towards events with differing probabilities can result in bad investment decisions – investing in a loser even, or missing out on a winner.

The theory is in direct contrast to the expected utility theory, which states that if people are given two outcomes, people will choose the outcome that makes them happiest (i.e. gives them the most utility).

Like all of our other terms this is relevant for everyday life and not just in financial markets. For wealthy individuals, studies have shown that the pain of losing wealth is greater than the benefit of gaining additional wealth.

With markets choppy and the downside risk arguably greater than the upside risk in markets, this could impact the US economy. With the top 10% of US consumers (those earning over $250,000) accounting for at least half of consumer spending, if perceived risk in the market is high this could cause these consumers to pull back spending (i.e. aiming to protect their wealth by spending less).

Data also shows that 87% of households earning over $100,000 hold stocks, while only 25% of households earning less than $30,000 hold stocks. Again, this perceived risk and aversion to loss could cause consumers to pull back their stock market holdings, which would lower demand and pull values down.

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