BRIGHT PAPER

AUGUST 2016

LOSS AVERSION *and* YOUR INVESTMENT PORTFOLIO

You're at a beach. It's hot, sunny and you want to cool off. Your day started well – after finding a $20 bill in the parking lot, you hide it in one of your sneakers and head to the water. When you come back, your shoe is empty and the $20 is gone. Easy come, easy go.

Well, the 'going' part isn't so easy, actually.

As part of their Nobel Prize winning research, psychologists Daniel Kahneman and Amos Tversky discovered that the pain people feel from a loss is about twice as strong as the pleasure felt from an equivalent experience of gain.[1]

So in our beach example, even though the outcome is neutral – you find $20 and you lose it – the pain of the loss will be more powerful – and will linger far longer. This fact creates a powerful behavioural bias called loss aversion.

When it comes to losing $20 at the beach, it's not a big deal. But it's another story when it comes to making long-term decisions about lifetime savings.

The strong desire to avoid loss could have two negative impacts:

- Cause you to miss out on portfolio growth opportunities.
- Cause you to take emotional actions after a loss, such as exiting the market entirely, that are contrary to your long-term investment goals.

[1] Kahneman, Tversky (1979, 1992).

Insight to *Opportunity*

When investing, one of the most significant tendencies is "loss aversion." Research* shows people tend to feel pain from losses about twice as strongly as they feel pleasure from gains. It's a powerful bias that can be a significant motivator in your decision-making. When people feel this pain during tumbling markets, they often act impulsively and "fly to safety." Modern market conditions continue to provide plenty of tumbles.

Interestingly, even with a lower Canadian dollar and oil prices, advisors remain optimistic about Canada's economy. In fact, this year's Market Sentiment survey by Sun Life Global Investments (Canada) Inc. shows recent market volatility hasn't changed advisors' long-term thinking. In this environment, advisors are having more frequent conversations with investors.

Once you understand what motivates you to make financial decisions—more specifically, what motivates you to make decisions that aren't necessarily aligned with your long-term goals—you can work with your advisor to find solutions to overcome them. That's what this paper is all about. It all begins with a better understanding of why you feel and act the way you do when you invest.

* Nobel Prize winning research by psychologists Daniel Kahneman and Amos Tversky (1979, 1992).

Millennials, and to some extent Gen Xers, are risk averse and conservative in their investing approach.* Given their long-term investment horizon, this perspective could be harmful to their retirement planning.

*Source: The 2016 Market Sentiment Report by Sun Life Global Investments.

A closer look at loss aversion

When we use the term loss aversion, we're really referring to three distinct but related aspects of human behaviour.

1. Our tendency to avoid losses

As discussed in our beach example, studies have clearly shown that people are more distressed about losses than they are happy about gains. As a result, our tendency is to avoid situations that could lead to a loss, even if the situation could potentially mean a greater reward.

For example, one study[2] presented subjects with a risk/reward opportunity that was designed to discover how much of a potential gain was needed for them to accept the risk of a certain amount of loss. The participants were asked whether they would accept an opportunity that had:

- a 50% chance of losing $100, but also
- a 50% chance of winning $150.

This is a great deal, as the potential winnings are significantly higher than the potential loss. Choosing not to accept this opportunity may be a poor choice, because the opportunity is worth $25 more than not participating, at least from a pure mathematical standpoint. But people don't always act practically, and in the experiments, they chose not to accept the risk. It was only when the potential gain was more than double the expected loss (more than $200) that more people chose to accept the gamble.

[2] Kahneman, Tversky, 1992.

2. Our tendency to take action when losses occur

If a loss does occur, this event will receive more attention and more thorough mental processing than good things.[3]

A good example is when a friend approaches you and says, “I’ve got good news and bad news – which do you want to hear first?” Research shows that more than three-quarters of people (78%)[4] want to hear the bad news first – as there is an urgency to hear it, process it, and potentially act on it.

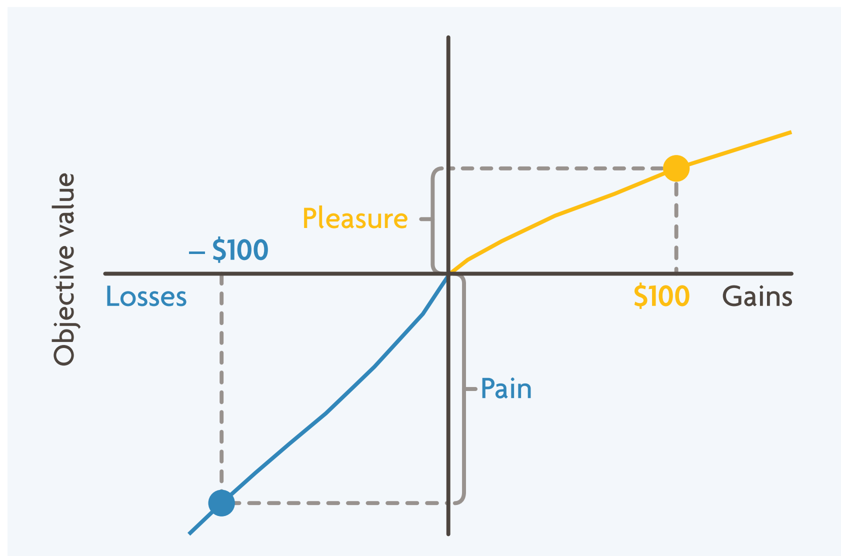
Simply put, bad events signal a need for change, good ones don’t. Sometimes, this can be a positive, adaptive response. For example, a negative reaction to a poor investment outcome could signal a need to get out of the investment, as not all investors are capable of foreseeing how they will react in the event of a loss. So dialing down the risk in that situation may be appropriate.

In other cases though, the urgency to act can lead to poor decisions in a long-term investment portfolio context. Despite best intentions to stick with a long-term plan, negative short-term events can have a significant impact on many investors, along with a desire to “fix” the problem by taking action quickly to reduce the risk of future losses.

Surprisingly, this reaction is even more significant with younger investors. According to the 2016 Market Sentiment survey by Sun Life Global Investments (Canada) Inc., recent market volatility has led younger investors to have more frequent conversations with their advisor. The survey also shows that younger investors say they’re being advised to make portfolio changes, so they’re coming away from these discussions feeling the need to do something.

The chart below, based on Kahneman and Tversky’s “Prospect Theory,” shows the pain of a loss is almost twice as strong as the pleasure from a gain. It’s a powerful force that can move investors toward short-term safe havens at times of crisis, at the expense of potential long-term growth.

LOSS AVERSION



> “I’ve been having more frequent conversations with my advisor because of recent market volatility.”
> Millennials – 48%
> Total group – 28%
>
> Source: The 2016 Market Sentiment Report by Sun Life Global Investments.

[3] Baumeister, Bratslavsky, “Bad is stronger than good”, Review of General Psychology, 2001.
[4] Markman, Art. “Why Hearing Good News or Bad News First Really Matters,” Psychology Today, June 2014.

3. Our tendency to seek certainty

Our brains don't like uncertainty. Dr. David Rock, author of "Your Brain at Work," describes our response to uncertainty as "like a type of pain, something to be avoided."[5] For this reason, we steer toward certainty, and feel rewarded when we achieve it, even if we may be better off over the long-term to remain uncertain.

Rock pointed out that "[w]hile the financial markets of 2008 showed once again that the future is inherently uncertain, the one thing that's certain is that people will pay lots of money to at least feel less uncertain. That's because uncertainty feels, to the brain, like a threat to your life."[6]

The need to at least feel less uncertain speaks to the key role that your advisor can play. Even if no actions are taken from a portfolio standpoint to lessen actual uncertainty, the decision-making support and practical perspective that an advisor brings to the table can reduce the feeling of uncertainty that many investors experience – and that alone can help avoid short-term over-reactions to bad events and keep them on a track with longer-term investment strategies.

43% of advisors cite staying the course as their most valuable advice given to clients over the past year.

Source: The 2016 Market Sentiment Report by Sun Life Global Investments.

20% of investors said they sold investments to raise cash over the past 12 months.

One-third of Millennials sold investments to raise cash in their portfolio over the past 12 months.

Half did so out of a fear of losing money.

Source: The 2016 Market Sentiment Report by Sun Life Global Investments.

Loss aversion and your investment portfolio

How does loss aversion factor into investment decisions? Assessing risk tolerance is foundational to building good portfolios and loss aversion is a key component needed to make that assessment.

Risk tolerance includes both the willingness and the capacity for taking risk. All things being equal investors with higher loss aversion will have a lower risk tolerance because the pain of loss makes them less willing to accept risks. However, if you understand how taking prudent risks can help you meet your long-term objectives, you may be willing to accept risks you would otherwise reject – not because your natural loss aversion is gone but because you know that dealing with the discomfort caused by volatility is in your best interest. It's the financial equivalent of eating your broccoli – you do it because it's good for you, not because you like it.

Half of investors (53%) view themselves as risk averse and conservative (52%) in their investing approach.

Half of Millennials (51%) and half of Gen Xers (49%) would settle for lower returns if it meant less volatility in their investments.

Reflecting their risk averse, conservative investing approach, Millennial portfolios are, on average, 31% sitting in cash.

Source: The 2016 Market Sentiment Report by Sun Life Global Investments.

[5] Dr. David Rock, "A Hunger for Certainty", Psychology Today, October 25, 2009.
[6] Dr. David Rock, "A Hunger for Certainty", Psychology Today, October 25, 2009.

Of course the opposite can also be true and investors, particularly those new to the investment world, may underestimate their aversion to loss while it's still theoretically causing them to sell when they experience market losses.

By understanding the different elements of loss aversion, you're in a better position to manage the impact it can have. But what exactly is that impact?

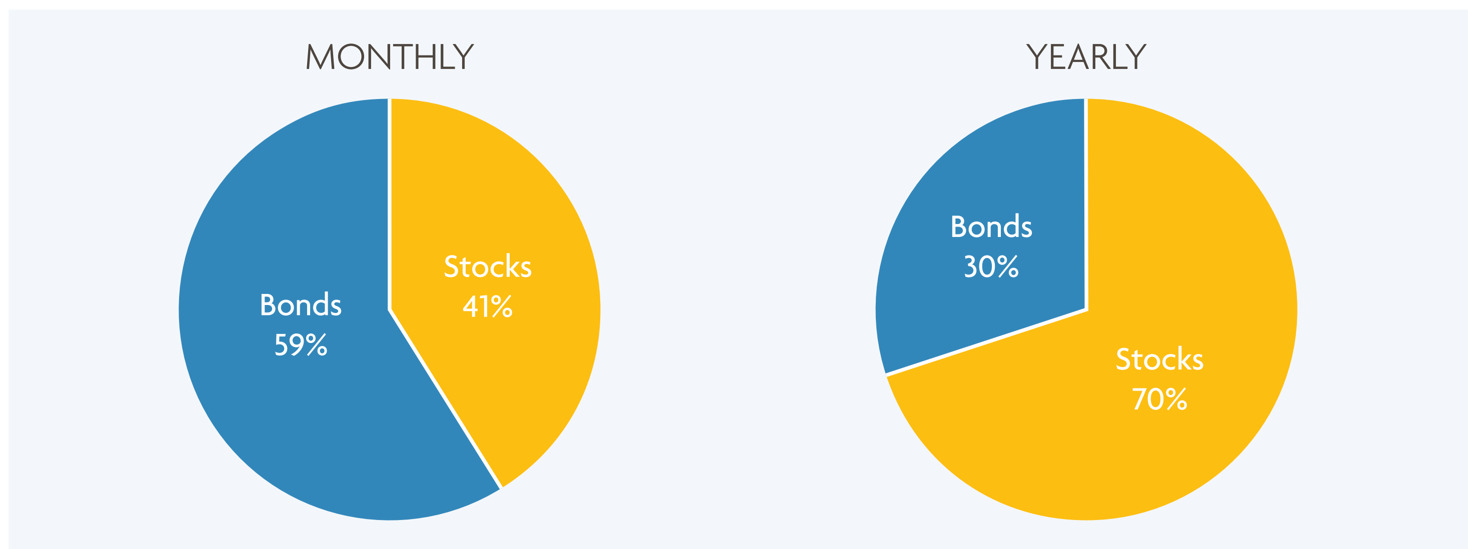
As it turns out, it could be a fairly profound one. According to the 2015 Investor Economics Household Balance Sheet Report, 32% of all financial assets held by Canadians were in bank accounts and fixed-term deposits at the end of 2014. While some of that money is undoubtedly invested appropriately to achieve short-term goals and satisfy a need for liquidity, loss aversion may be playing into the high level of low-yielding assets held by Canadians.

And the problem with that is simple: growth-seeking asset classes, such as equities, are critical to the long-term wealth creation most Canadians will need to retire well. By seeking safety in bank accounts and fixed-term deposits, you may be trading potential market losses for potential negative real returns, especially when the impact of inflation is factored in. This is the ultimate lose-lose situation for those with a long-term timeframe.

Even for investors who hold an equity portfolio, those who check performance frequently stand a greater risk of reducing their equity exposure over time, due to the unsettling nature of the inevitable fluctuations they observe. This effect is called "myopic loss aversion" – a specific form of loss aversion where the greater sensitivity to losses than to gains is compounded by an investor's frequent reviews of portfolio fluctuations. This problem has grown now that we can access portfolio information at any time online.

IMPACT OF FEEDBACK FREQUENCY ON INVESTMENT DECISIONS

The graphs below show the results of a study where investors, under simulated conditions, made portfolio decisions. One group received portfolio feedback on a monthly basis, the other on a yearly basis. It's obvious the loss aversion bias had a significant impact when portfolio performance was monitored monthly, as exposure to growth assets is much lower when the portfolio was checked on a more frequent basis.



Note: In the study, subjects were assigned simulated conditions that were similar to making portfolio decisions on a monthly or yearly basis. Source: Thaler, Tversky, Kahneman, Schwartz, 1997.

While the path of equity markets has been a rising one historically, that rising path has never been a straight line up. There are many declines along the way – and investors who check their portfolios frequently will feel each and every bump – along with the uncertainty that results. And as the charts show, these actions greatly enhance the loss aversion bias, with a resulting decline in equity market exposure.

Ways to deal with a loss aversion bias

WHILE LOSS AVERSION IS A POWERFUL, PROVEN BIAS, THERE ARE SEVERAL STRATEGIES THAT CAN MANAGE ITS IMPACT.

Understand the need for growth

People have a natural bias against losses – but exposure to equities may be critical to achieving long-term portfolio goals. Working with an advisor to understand how the markets will fluctuate will be especially important when equity markets inevitably experience volatility.

And to the extent you can resist overly frequent reviews of portfolio performance, the more you'll be able to avoid issues of myopic loss aversion that can trigger a desire to exit market investments.

How you frame information can also have a significant impact on how you see things. Instead of thinking a portfolio has a 10% chance of loss after 10 years, take another look and see that the same portfolio has a 90% chance of experiencing gain in the same time period. Then ask yourself if the potential gain is worth the risk.

Diversity

A diversified portfolio – with exposure to different asset classes and world regions – delivers a much smoother ride in terms of performance volatility. This can reduce the impact of equity market declines on a portfolio, and reduce the chances of an investor exiting the market against their longer-term best interests. Working with your advisor for ongoing rebalancing is critical to maintaining the right exposures and providing the smoother ride that will help keep you calm and invested.

Consider guaranteed wealth products

It's time to re-evaluate the role and importance of guaranteed wealth products through the lens of the loss aversion bias. There are many new and innovative wealth products that provide important income and capital guarantees. And while there is a cost to this insurance, there can be a far greater cost if investors with long-term goals avoid exposure to growth investments.

Guaranteed wealth products address loss aversion by allowing exposure to the growth potential of equity markets while providing some certainty and predictability through their guaranteed features. They can give loss averse investors the confidence to enter the market – and the reassurance needed to stay invested when markets decline.

Have the right conversation with your advisor

Years of academic research make it clear – loss aversion is an innate human trait, and it impacts investment choices and strategies as much as any other life decision. Rather than fight against this ingrained bias, consider talking with your advisor about:

- your risk tolerance,
- loss aversion and how it can impact your long-term goals, and
- your portfolio options and re-balancing when necessary.

Embracing and understanding this particular aspect of human nature can reassure you and help you stay invested and reap the rewards of long-term portfolio growth.

KEY HIGHLIGHTS

- Research shows the pain people feel from a loss is about twice as strong as the pleasure felt from an equivalent experience of gain – a bias known as loss aversion.
- In a portfolio context, this strong desire to avoid loss could cause investors to underweight growth investments, even if their goals are long-term.
- Loss aversion can cause investors to take emotional actions after a loss that are contrary to their long-term investment goals.
- You can counter the impact of the loss aversion bias in several ways: understand the need for growth (see both sides – the negative and positive); diversify your investments and rebalance on a regular basis; and consider guaranteed wealth products that provide growth upside with downside protection.

About Sun Life Financial

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We are dedicated to helping Canadians build and preserve their wealth – and achieve lifetime financial security.

**We're dedicated to helping you achieve lifetime financial security.
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Life's brighter under the sun

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