Risk aversion is hard wired into us as investors

Risk is the elusive concept which most find difficult to explain, and for investors to grasp. As humans we are naturally risk averse. The chemical responses in our brain show that when we make money we get a "high" like we get when we eat chocolate or drink coffee, it makes us feel good. When we lose money, the chemicals in our brain takes us back to our "cave man" fear of danger – get me out of here! Then when there were wild animals that could kill us, was a logical response but when investing for your future, it is illogical and counter intuitive.

Below is one of the common psychological money questions that are asked:

1. You have R1, 000 and you must pick one of the following choices:
   Choice A: You have a 50% chance of gaining R1, 000, and a 50% chance of gaining R0.
   Choice B: You have a 100% chance of gaining R500.

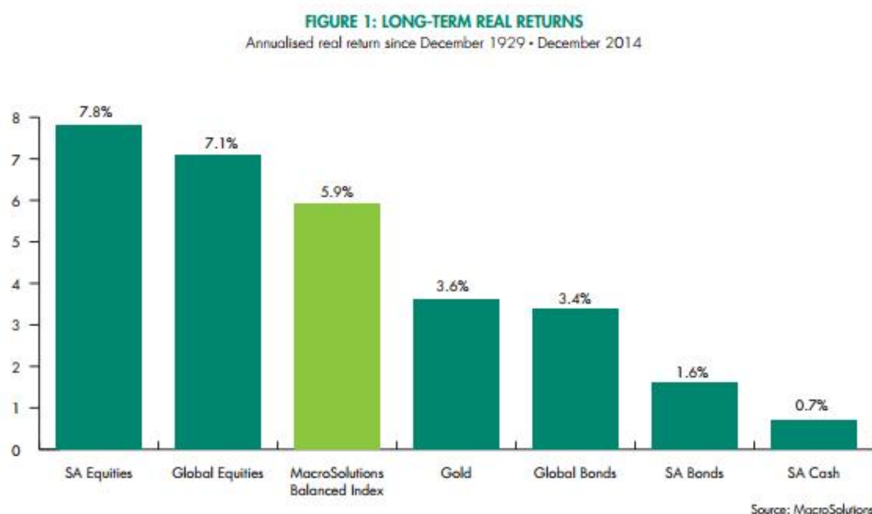
2. You have R2, 000 and you must pick one of the following choices:
   Choice A: You have a 50% chance of losing R1, 000, and 50% of losing R0.
   Choice B: You have a 100% chance of losing R500.

Rationally, we should be ambivalent between the two choices, however research suggests that by far the majority of respondents select option B for the first question, and option A for the second, highlighting the preference to limit losses relative to the tendency to acquire gains.

For investors this can lead to a material risk aversion bias which reflects in their investment portfolios. This bias plays out in many ways: retaining high levels of conservative investments, or even cash when you should be more fully invested; preferring bricks and mortar property over uncertain shares; or even selling a good investment when it has performed strongly. Each of these are examples of risk aversion playing out in a way which may not make rational sense given the investors capital growth requirements.

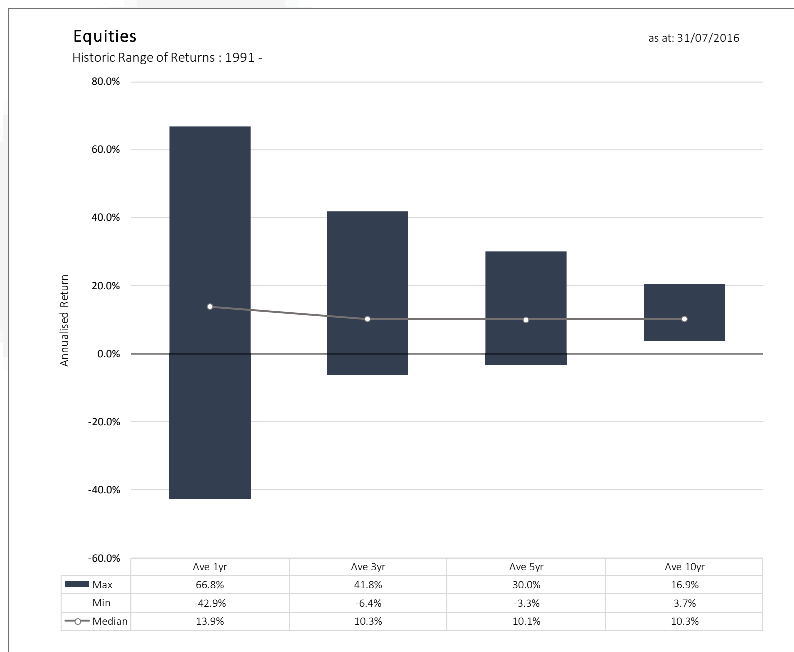
The trouble with risk aversion in investing is that it is counter-productive. We are, after all, trying to generate capital growth which by its very nature, is a pursuit which assumes risk taking behaviour. We have a constant struggle against ourselves to ensure we are taking sufficient, and appropriate, risk.

To demonstrate this impact on wealth creation, consider the long term asset class returns and the premium which investors have earned by exposing themselves to risk:



Local SA equities have been the best performer by some margin and created the most wealth for investors, however the ride has not been so smooth:

Range of returns of the JSE: 1991 -



Source: Fundhouse

The range of returns indicated above, where the largest annual loss has been over 40%, makes it very difficult for investors to take on this risk. Without it though, investors are short a material tool in creating wealth.

Embedded in this world of risk is essentially every moving part of the global economy: politics, interest rates, credit risk, the weather, fraud, poor management, dying business models – an endless list. Risk encapsulates everything and does not discriminate. How then do we deal with it, knowing that it is an essential building block in any growth portfolio?

To start with, the role of the financial planner is critical in assessing the *need* to take risk. For most investors this need is clear: capital growth, wealth creation, retirement being the obvious goals for many. Defining this investment objective is a non-negotiable starting point.

Implementing this goal and sustaining this goal can be more difficult, especially when the risk aversion sets in. To start with, it helps to mitigate against risk with some due diligence steps to ensure the obvious risks are avoided: selecting a good independent financial adviser; due diligence on investments; making sure fees are fair. This step by step process can help an individual take the steps towards accepting higher levels of risk in line with their needs, and help them rationalise the process with their long term objective when it becomes emotionally more difficult to take this risk on.

Fund managers (being humans as well) are also risk averse for the large majority. This is seen in their investment decisions, where they are quicker to reduce risk, than they are to assume it. Selecting the good performing managers is exceptionally difficult; selecting managers who can manage risk is substantially easier.

Once invested, the risk continues! Monitoring investments and avoiding the behavioural trappings (buy on greed, sell on fear being the most value destructive) are risk management steps which help preserve and grow capital. For the most part, you should, as an investor, be able to leave a portfolio to deliver the goods.

Ultimately, erosion of wealth is the ultimate risk for investors, and the odds are highest of this occurring when insufficient risk is taken. With markets being as volatile as they are, it is important to be mindful of your long term goal, don't react to short term volatility when your end game is 5- 10 – 15 – 20 years from now.

Spot Rates

31-Aug-16		5-Sep-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US$	Rand	14.38	14.70	12.17	6.76	7.15	4.33
Rand/GBP	Rand	19.12	19.56	19.07	10.83	13.22	6.71
Rand/EUR	Rand	16.04	16.31	13.54	9.80	9.09	5.14
Rand/Aus $	Rand	10.91	10.97	9.36	7.24	5.31	3.42
Libor 6m $	US$	1.25	0.92	0.44	0.40	5.59	N/a
Prime	Rand	10.50	10.50	9.25	9.00	11.00	20.50
Repo Rate	Rand	7.00	7.00	5.75	5.50	7.50	N/a
All Bond Index Yield	Rand	8.88	8.84	8.51	8.72	10.00	13.72
Gold ($/oz)	US$	1,325.50	1,321.86	1,172.97	1,500.91	614.25	381.15
Palladium	US$	676.00	589.00	677.00	761.00	312.00	132.35
Platinum	US$	1,074.00	1,023.00	1,078.00	1,725.00	1,227.50	389.00
Oil (Brent Crude) $	US$	47.47	50.06	63.35	111.85	72.85	19.05
SA Inflation	Rand	6.00	6.30	4.70	5.00	4.90	6.90

Data provided by Profile Data Analytics and INET BFA