What is Risk to You: Volatility or Fear?

November 1, 2016 by Teoh Hock Geh (Gavin)

Risk means different things to different people. Your financial planner, agent or banker may have asked you to do a risk profiling test to analyse your risk appetite and find a suitable asset portfolio as part of their recommendation process. If you didn't, I would suggest you to do one, and if possible, one with psychometric risk profiling.

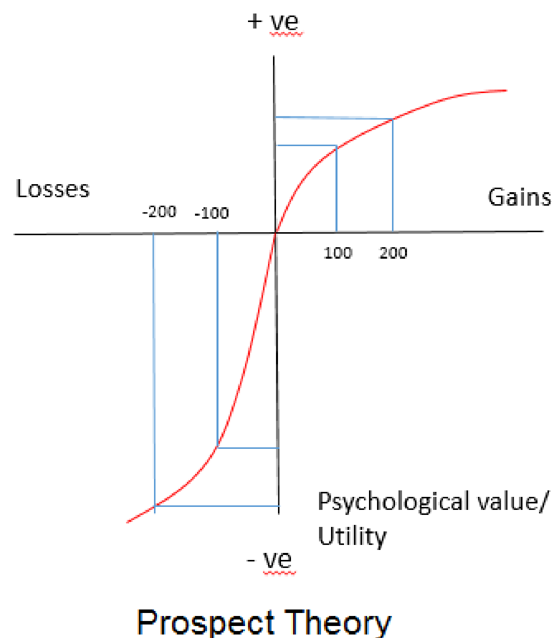
So, what is the significance of having your risk tolerance examined? Some say for trading activity, it is immaterial and it may only apply to those interested in investment for long term only, how true is this statement?

With the ebb and flow of markets or through your personal nightmare experiences in going through market crisis, you may have developed certain understanding and attitude towards risk. Typically, for professionals like financial planners, risk means volatility. They like to use technical terms like standard deviation, beta and alpha to show the vulnerability and relativity of risk against market and peers.

How well you understand these jargons? Do they mean anything to you? Would negative news such as political instability, weakening of the Ringgit and economic slowdown be more destructive to your heart than all these technical numbers? Psychological studies show that the layman investor sees Risk as an enormous problem and defines it differently compared to professionals' interpretation. For many investors, these unfavorable conditions spell trouble for the market and will affect their trading or investment activities. They develop worries and have fear of putting their money in the market - that is what Risk means to the layman!

Behavioral finance research shows that people naturally have risk aversion in different degrees towards investing money. Without any formal risk examination, our limitation of risk taking can be identified from our loss aversion, which is our emotional inclination to unfavorable conditions in the market. The Prospect Theory (Kahneman and Tversky, 1979) discovers that, in general, people feel a stronger impulse to avoid losses than to acquire gain. Psychologically, a RM100 loss is two times more painful than the happiness from a gain of the same amount (See diagram of asymmetrical utility graph in next page).

The asymmetrical utility graph in the study also shows that people like gains but hate losses more. We wouldn't continue to have the same quantum of happiness from a gain after we had gained substantially. Psychologically, this may stimulate our greed to look for a higher quantum of gain. Similarly, we also would feel less pain from any further small loss after we had suffered a great loss, and this causes us to become irrational in taking unnecessary risk to improve our investment return. In fact, we experience this diminishing sensitivity when evaluating the changes of wealth. Therefore, it is true to say a compulsive gambler would continue to wager for greater return with higher quantum of profit and endure more risk with step-up losses - this irrationality eventually cause financial disaster to his own life.



Prospect Theory

Source: Thinking, Fast and Slow, Daniel Kahneman

Sometimes, however, defects arise in our natural risk aversion behavior. When we have loss aversion bias, we tend to make unusual financial decisions. In this context, we have the unintentional inclination to develop risk seeking and risk avoidance behaviors. In psychology, we call it 'disposition effect'.

Risk Seeking

Let's look at the recent tumble in oil price since mid-2014. We experienced a meltdown in the price of oil- and gas-related stocks. There is a slim probability of a quick rebound in oil price and the recovery of the industry seems beyond the short to medium term horizon. Would you sell the offending stocks and redeploy your investment portfolio if you have substantial holdings of such stocks? Or do you have a love affair with your losing stocks? Most of us will hold on to a losing stock, hoping to recover the losses. But then, holding on to a losing stock in such a situation means you are risk seeking when in fact you should behave rationally and be risk averse!

Risk Avoidance

In another situation, you may have made some profits in certain winning stocks. Do you lock in the profits, fearing that your investment will tumble and your returns will evaporate if the market reverses itself? You may think that this is a great strategy - to sell the winning ones and to preserve the entire portfolio's return – but, in reality, this behavior limits upside potential of specific stocks or funds and affects the entire portfolio's growth. Thus, we develop risk avoidance behavior, and selling our winning assets too early too frequently may lead to too much trading, which can jeopardise our overall investment return.

As far as risk is concerned, it is a very individual matter. There is nothing wrong with being a conservative or an aggressive investor. We just have to understand our own perception of risk and not allow our emotional biases to determine our investment decisions. We can construct a well- diversified investment portfolio which reflects the true nature of our behavior and setting a pragmatic expected return with tolerable risk taking. A clear investment philosophy will guide, remind and help us to uphold our investment principle in overcoming the ups and downs of the market. Remember "Don't make financial or investment decisions on the basis of emotion".

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