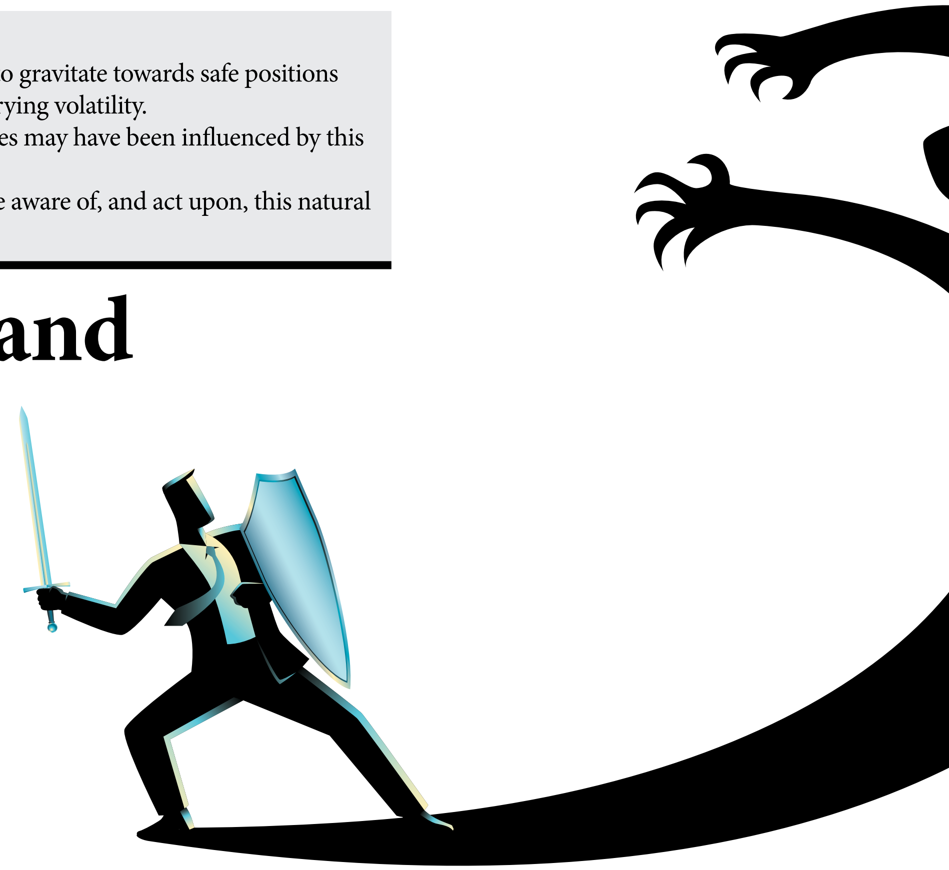
Summary
- Loss aversion is a human's innate tendency to gravitate towards safe positions when confronted with different options of varying volatility.
- DB trustee boards decision-making processes may have been influenced by this aversion to risky investments.
- There may be a need for trustee boards to be aware of, and act upon, this natural 'fear of loss' in order to maximise gains.

Feel the fear and do it anyway



Paul Beardwell explores the effect of the human tendency for loss aversion on trustee boards' decision-making

If somebody were to be approached by a trusted colleague or friend, right now, and offered a cheque for £100, no strings attached, they may be inclined to accept it.

However, just before it is handed over a caveat is introduced. The £100 may be taken immediately. Or it can be refused, and tomorrow morning two unmarked envelopes will be offered in its place. One containing a cheque for £1000 and one containing nothing at all. Only one of those envelopes can then be chosen and the contents must be accepted. This situation could either lead to a ten-fold increase on 'yesterday's potential gain', or a net profit of zero. What decision would you take?

This is a simple way of demonstrating the concept of loss aversion. An individual with an increased aversion to risk would most likely accept the cheque for £100 immediately. Even though the future reward may be ten times greater based on what is essentially a 50/50 gamble.

Avoiding risk

The human propensity towards risk aversion is a subject that has been the focus of a number of studies over the years. The majority view appears to be that humans have an innate tendency towards the mitigation of loss. A paper, *Who's Afraid of a Little Risk? New Evidence for General Risk Aversion*, by Princeton University professor of psychology and public affairs, Elke U. Weber, states: "While there is evidence that a small proportion actually like options that they perceive to have greater risk and are willing to pay more money for these options than for options of equal expected value but smaller perceived risk, this is not true for most people."

Asked to define risk aversion, Dalriada Trustees professional trustee, Andy Scott, proposes it is: "The desire (and actions taken) to avoid any adverse consequences of a decision or future event. It usually arises because people worry more about the downside and what can go wrong than take risks to achieve an upside."

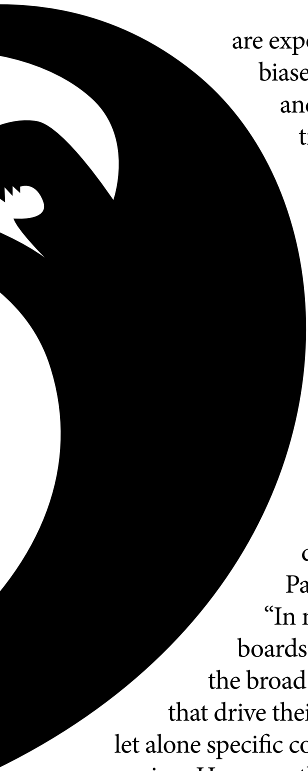
This innate human 'fear' of loss may drive trustee members to make certain, safer, decisions that could be preventing them from realising potentially greater returns.

Cowry Consulting behavioural consulting lead April Vellacott explains: "Trustee boards are no exception to this bias. When weighing up a novel approach or opportunity, they'll be tempted to focus on the potential risks and costs, known as loss aversion. This is because we feel the impact of losses twice as much as equivalent gains."

Awareness

Trustee boards may not be aware of this innate bias. After all, they are not required to be experts in human psychology.

However, Cardano director Stefan Lundbergh acknowledges that: "Trustees



are exposed to the same biases as the rest of us and I think that most trustees are aware of their own biases. But as an individual, it is extremely difficult to mitigate our own biases, especially when making decisions under pressure."

In contrast, Redington head of governance and decision research, Paul Richards, says: "In my experience, many boards are not aware of the broad behavioural issues that drive their decision making, let alone specific concepts such as loss aversion. However, this is changing, with professional trustees often being a driver."

Examples

Richards also understands the difficulties that some board members may have when making decisions. "Trustees constantly have to make high-stakes choices in complex areas outside of their professional expertise. These factors can, understandably, lead to more tentative decision making," he explains.

Scott gives an example of this tentative approach: "There is a desire for trustees to hedge most or all risks in pension scheme investments, leading to the lowest interest rates ever recorded and guaranteeing that gilts will provide negative real returns for many years into the future."

Trustees' own awareness of loss aversion tendencies may be nuanced, depending on the individual risk capacity of each member of the board and how that board works together.

Richards makes the following distinction: "A scheme that needs a high level of investment return, but which has a board of highly risk-averse individuals, is likely to struggle to make the choices that need to be made. Here, the group dynamic is likely to reinforce preferences. While a board with different levels of risk aversion has less likelihood of defaulting to a low-risk position. However, diversity of preferences does not guarantee a good outcome. In some cases it will simply lead to nothing being agreed and the status-quo being retained."

Trustee boards leaning towards 'safer' positions is a theme that seems to hold a lot of weight with industry professionals.

For example, "the slow adoption rate of integrated risk management (IRM) can be explained by a concert of human biases, of which loss aversion is one", Lundbergh states. "From a logical perspective, a scenario-based approach to IRM makes perfect sense since it helps trustees to make the funding ratio more resilient, but in some cases the 'current practice' will deliver better outcomes. Framing the latter as a risk, means that loss aversion will nudge decision making towards status quo."

Lessening impact

In order to lessen any negative implications of risk aversion, the framing of loss may need to be re-evaluated so that it can be presented and considered in a more positive way.

"Trustees can frame risky approaches in terms of the potential benefits, rather than ruminating on potential losses. Instead of leading with 'this is going to cost us £35,000', try introducing a risky approach with, 'this has the potential to bring us an extra £100,000 in revenue'. By framing risks in terms of their potential gains, this will help trustees to overcome their natural inclination to shy away from risk," Vellacott says.

Trustee boards' advisers may also be able to help trustees adjust their inclinations towards loss aversion.

"Consultants and advisers can play a key role by ensuring the thought and decision making is objective and by challenging trustees in considering an alternative view," Columbia Threadneedle Investments senior thematic analyst and behavourial economist Dr Ben Kelly says. "This is not per se designed to force trustees into changing their minds, but to ensure the decision they do make is grounded within an objective and routine process."

Scott agrees with this principle. "I think that education, good governance and chairmanship, and good consultants/advisers will go a long way to mitigating any unnecessary caution in trustee decision making," he says.

Benefits of loss aversion

So far loss aversion has been framed as a potentially negative influence. M&G director, fixed income, Annabel Gillard, brings our attention to an alternative position. "It's inherent in trustees' nature to be risk averse given they are responsible for the scheme's performance. A degree of risk aversion is also appropriate, given trustees are exercising a fiduciary duty on behalf of members," she explains.

Scott agrees, stating: "Avoiding bad risks are very much what trustees are there for, so there should not be a mad rush into taking reckless or unnecessary risks. That is for the gambling casinos and racetracks. Trustees should never totally abandon caution – it is a natural outcome of being prudent."

The human tendency towards loss aversion plays an intangible, but still important, role in trustees' decision making and risk analysis. Therefore, greater awareness of its impact may make a significant difference.

As Legal & General Investment Management head of DC client solutions, Simon Chinnery, articulates quite succinctly: "If board trustees are tutored to recognise behavioural traits and can practice in a healthy environment where it is acceptable to challenge one another, then great."

Written by Paul Beardwell, a freelance journalist