BEHAVIORAL FINANCE 101 -
LOSS AVERSION & ENDOWMENT

Modern economic and investment theory rests on a foundation that assumes people are rational and markets are efficient. However, people often think and act irrationally and real financial markets rarely resemble textbook models of efficiency. Individually and collectively, we have errors and biases in our thinking and emotions.

This month we will discuss two emotional biases: Loss Aversion and Endowment.

Loss Aversion

Suppose you are investing $1,000 and have to choose between (a) a sure gain of $500 or (b) a 50% chance to gain $1,000, but also a 50% chance to gain nothing. Which would you choose?

Now, suppose you have $2,000 to invest and are facing a choice between (a) a sure loss of $500 or (b) a 50% chance to lose $1,000, but also a 50% chance to lose nothing. Which would you choose?

In the first example, most people choose (a) the sure gain of $500, but in the second example most choose (b) indicating they are willing to assume the greater risk of losing $1,000 rather than face the certain loss of $500.

This isn't logical, but it is how we think. We don't like losses. The pain of losing $1 greatly exceeds the pleasure of gaining $1, so many are too-willing to accept a greater risk to avoid the pain of a loss.

Let's say you bought a stock and paid $50 per share, only to watch it drop to $40 a share. Would you keep or sell the stock? Far too often, you keep the stock simply because selling it would make the loss "real" to you. As long as the loss is just on paper, you can postpone the pain while you wait and hope to sell the stock for a better price – at least what you paid for, so you won't have a loss. Of course, whether you admit it or not, the loss has taken place and the more appropriate question is whether this particular stock or a different stock provides a more compelling opportunity at this moment in time.

Loss aversion can also manifest itself by selling your better performing investments too quickly, while at the same time hanging onto poorer performing investments.

Loss aversion leads you to excessively focus on the short-term volatility of a portfolio, instead of the expected long-term performance of your investments. Also, rather than viewing your portfolio as a whole, where each investment has a role to play, it makes you myopically examine each individual investment, losing sight of the big picture.

Endowment

The endowment effect says that simply owning an item causes you to value that item more than similar items you don't own. This could be a personal item, real estate, an inherited stock, or investments in your 401(k) plan.

I’ve often observed someone reluctant to sell an asset they inherited from their parents – they think of it differently from other assets. In addition, the single-largest holding for many employees is stock in their employer, because they “know” or “feel comfortable” with it. The longer something is owned, the more emotionally attached we become to it and the less willing we are to part with it, regardless of its investment merits.

A simple exercise to help overcome the endowment effect is to ask yourself, “if, instead of owning this particular asset, I had the value that it represents in cash, would I go back and buy it at all, or in the same amount that I own it today?”

In what ways has behavioral finance impacted your decisions? We’re here to help as you plan for your future.

Gerald A. Townsend, CPA/PFS/ABV, CFP®, CFA®, CMT is president of Townsend Asset Management Corp., a registered investment advisory firm. E-mail: Gerald@AssetMgr.com