The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 7 - Issue 11

Behavioral finance

How loss aversion and the endowment effect influence your financial decisions

By Stan Clark - Senior Investment Advisor

With investing, knowing when to sell – when to take a loss and when to take a profit – is often just as important as knowing what to buy.

Two biases can cloud our judgment and prevent us from selling investments that we should in fact be selling. These biases are called *loss aversion* and the *endowment effect*.

Let's look first at loss aversion. Now, standard economic theory holds that people take risks based on the utility of potential gains, balanced by the dis-utility of incurring losses. However, this balanced version of utility doesn't hold sway. Nobel Prize winner Dr. Daniel Kahneman asserts we're far more influenced by losses than by gains.

To illustrate, Kahneman poses two unusual choices in his book *Thinking Fast and Slow:*

1. Would you rather get $900 for sure, or gamble on a 90% chance of winning $1,000 with a 10% chance of winning nothing?

2. Would you rather give up $900 or gamble on a 90% chance of losing $1,000 with a 10% chance of losing nothing?

The two choices mirror each other. Yet in the first, most people would take the certain $900 over the substantial chance of winning more. It's the bird-in-the-hand concept: Most people are risk-averse.

In the second choice, loss avoidance, we would rather gamble and risk losing even more money because of our faint hope of losing nothing. It's a major reason people hold on to a falling stock far longer than they would if they gave proper weight to the stock's fundamentals. Selling means taking a loss, so people gamble on the stock recovering. Often they end up simply adding to their loss.

Now let's look at that curious influencer, the endowment effect.

Every day people exchange money for goods, or goods for money. Nobody thinks anything of it. As Kahneman notes, they mentally earmark the money and the goods as being "for exchange."

But sometimes it's different. Remember the *Seinfeld* episode where Jerry craves a loaf of marble rye bread worth $3? A woman in line ahead buys the last loaf. Jerry offers $50 for it. But the woman refuses, ultimately goading Jerry to become a loaf thief!

With the endowment effect, people place far more value on things they already own than they would to buy them. The woman likely wouldn't have paid much more than $3 for the loaf. But once she owned it, she didn't want to part with it, even for an outrageous price.

The endowment effect happens when people develop an emotional attachment to things. We see it with tickets to major sporting events such as the Super Bowl, the Stanley Cup and Olympic Gold Medal events. People refuse to sell their tickets, often giving up thousands of dollars – amounts they would never pay for the same tickets. Similarly, people can develop emotional attachments to their investments. They hold on to them even though they're priced far higher than their actual worth.

Beware of loss aversion and the endowment effect. Don't develop emotional attachments to your investments. Instead ask yourself, "If I didn't own this investment already, would I pay the current market price to buy it?" If you wouldn't, then maybe you shouldn't own it. Using a disciplined approach to buying and selling can help you avoid these biases and the mistakes they can cause. ■

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

CIBC Wood Gundy | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca

Stan Clark is an Investment Advisor with CIBC Wood Gundy in Vancouver, BC. The views of Stan Clark do not necessarily reflect those of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.
If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.