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Behavioral Finance

HOW LOSS AVERSION AND THE ENDOWMENT EFFECT CAN CLOUD YOUR FINANCIAL DECISIONS

By Stan Clark, Senior Wealth Advisor

With investing, knowing when to sell – i.e., 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 we should be selling: *loss aversion* and *the endowment effect*.

Let's look first at loss aversion. Standard economic theory holds that people take risks based on the utility of potential gains, balanced by the dis-utility of incurring losses. This balanced version of utility certainly sounds good. In reality, though, it doesn't often happen. According to Nobel Prize winner Dr. Daniel Kahneman, 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 idea: 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 simply add to their loss.

Now let's look at the second bias: 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 ahead in the line buys the last loaf. Jerry offers \$50 for it. But the woman refuses, ultimately goading Jerry into becoming a loaf thief!

With the endowment effect, people place far more value on things they already own than on things they would have to buy. The *Seinfeld* 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 competitions. 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, even though these investments are 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 a Portfolio Manager and Senior Wealth 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.

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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

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