Lecture 27

Loss Aversion

Loss aversion theory states that losses have a bigger negative impact than equivalent gains have positive impact. This means that the negative feelings associated with giving up an object are greater than the positive feelings that are associated with acquiring that same object. This is what actually explains some of the observations in the endowment effect and in the status quo bias.

Studies have been done to test the behavior of people when faced with a decision that can impact them in both a positive and a negative way. Each group tested was placed at a different reference point (current situation) in a way that their decision will affect their current situation in both a positive and a negative way. Both groups made decisions based on their reference point. They both made decisions that would limit the loss from their reference point instead of making their decision based on the gain that they could achieve from a different decision.

There have been many studies that have shown that losses are twice as powerful as gains. This is because when loss occurs there are strong feelings of blame and regret. These feelings and the anticipation of having these feelings affect us so much that we overvalue the impact of a loss over a gain.

How itaffects our trading:

Traders tend to view loss in a more intense manner then they view gain. They also view loss from a reference point of where they have been. For example if a trader started the days at zero dollars and finished at 500$ he might be happy. But if he went all the way up to 1000$ of profit and then finished the day at only 500$ he won't be happy as his reference point is now 1000$ and the loss of 500$ feels greater than the gain of 500$.