

Lecture 28

Endowment Effect

This anomaly has been heavily studied and has shown that we place greater value on something when we own it than when we don't own it. Basically if I asked you to place a dollar value on a mug, if I gave it to you first (so that you are its owner) you would place a higher value on it than if I hadn't given it to you. Multiple studies have shown this. As soon as we own something we place greater value on it. This brings us to the point that we demand way more to give up something that we own than we would have paid for it if we didn't own it.

Studies on this anomaly were done by grouping, randomly, groups of logical and smart people, and distributing to half the group an object. They then proceeded to ask the group to value the object. The part of the group who had the object valued it twice as much as the people who didn't receive it. Through many studies this anomaly has appeared where the willingness to pay for something we don't own is low compared to the willingness to accept a payment for the same thing if we did own it.

Initially we thought that we place greater value on the thing we own because we see it as more attractive than it actually is. Further studies have shown that people actually see the object they own in the same way that people who don't own see it. So it wasn't the fact we view it in a more favorable way that increased our value of the object. Turns out to be that we over evaluate the pain it would cause us to lose something that we own.

How it affects our trading:

We place greater value on a stock we own than if we didn't own it. Because of this we are biased and tend to keep positions way longer than we should. I sometimes tell traders to liquidate their position just for ten minutes and if after ten minutes they still want to get back into it they can buy it back. Every time I have done that the trader didn't buy back the stock as they didn't value it in the same way they did when they had the position. As soon as they liquidate the stock it seems there is an instant dis-endowment effect that happens and they can see that they do not think this position is good value.