M2L12. Endowment Effect

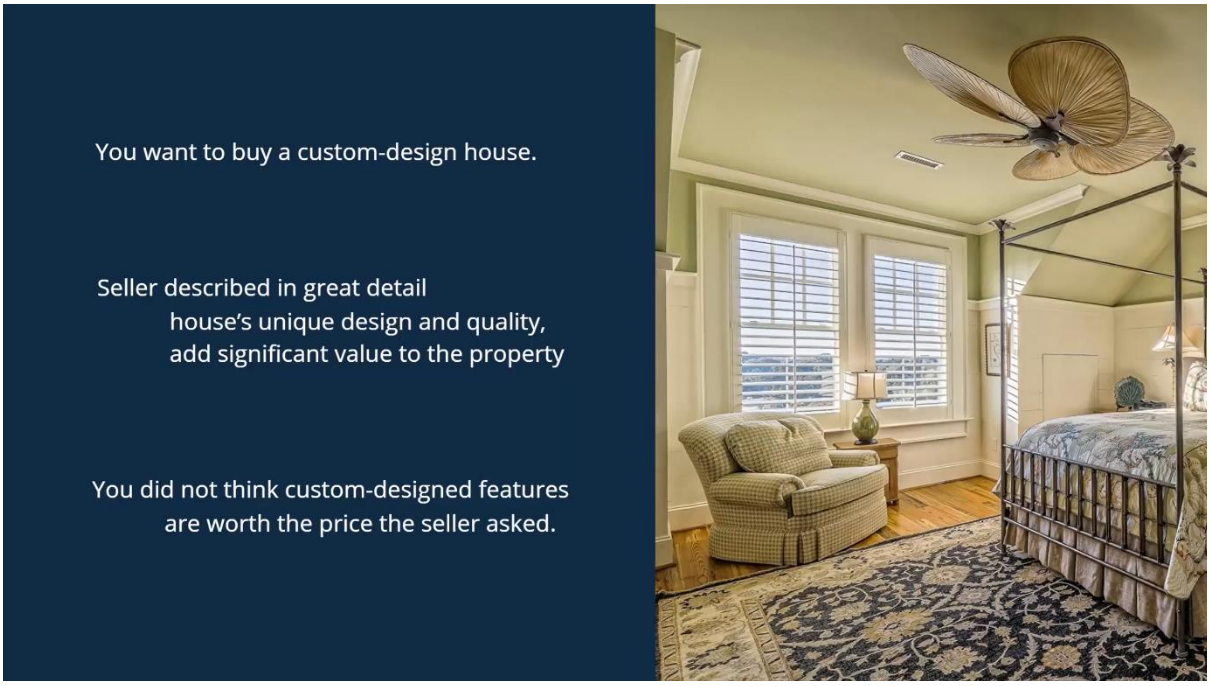
Slide #1

In this topic, we will discuss the endowment effect.

Slide #2

How many of you have had one of the following experiences?

Slide #3

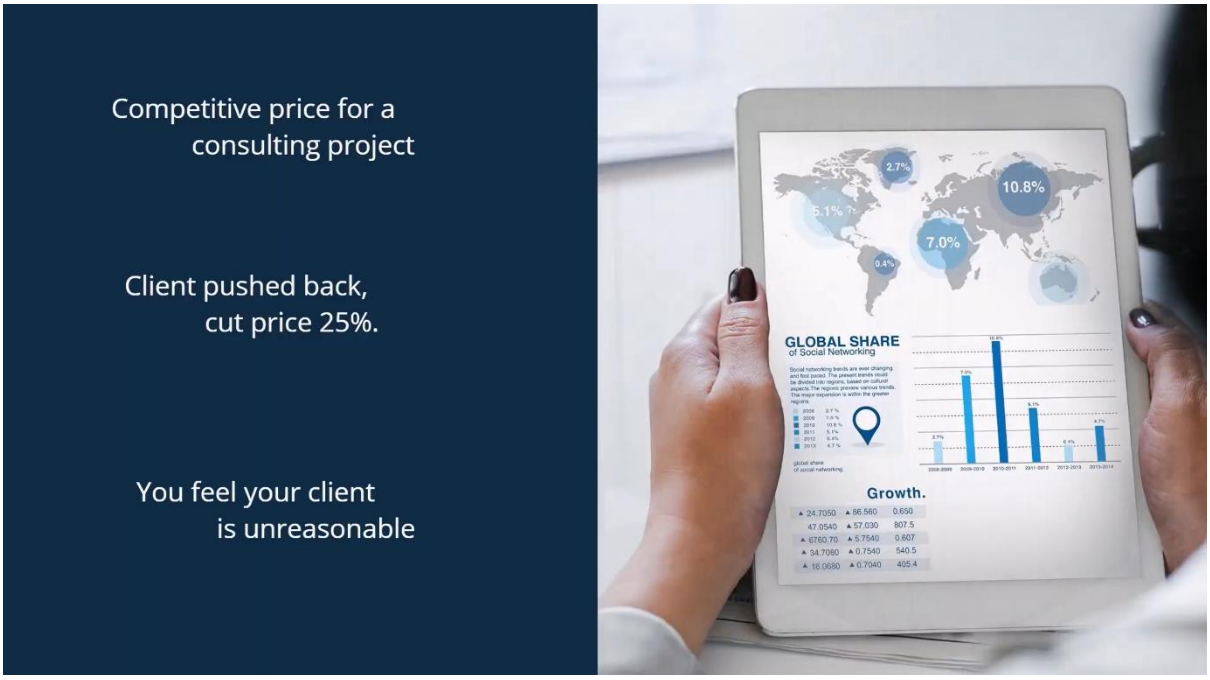


First, you want to buy a custom-design house.

The seller describes in great detail the house's unique design and quality, which adds a significant value to the property.

But you do not think these custom design features are worth the price that the seller asked.

Slide #4

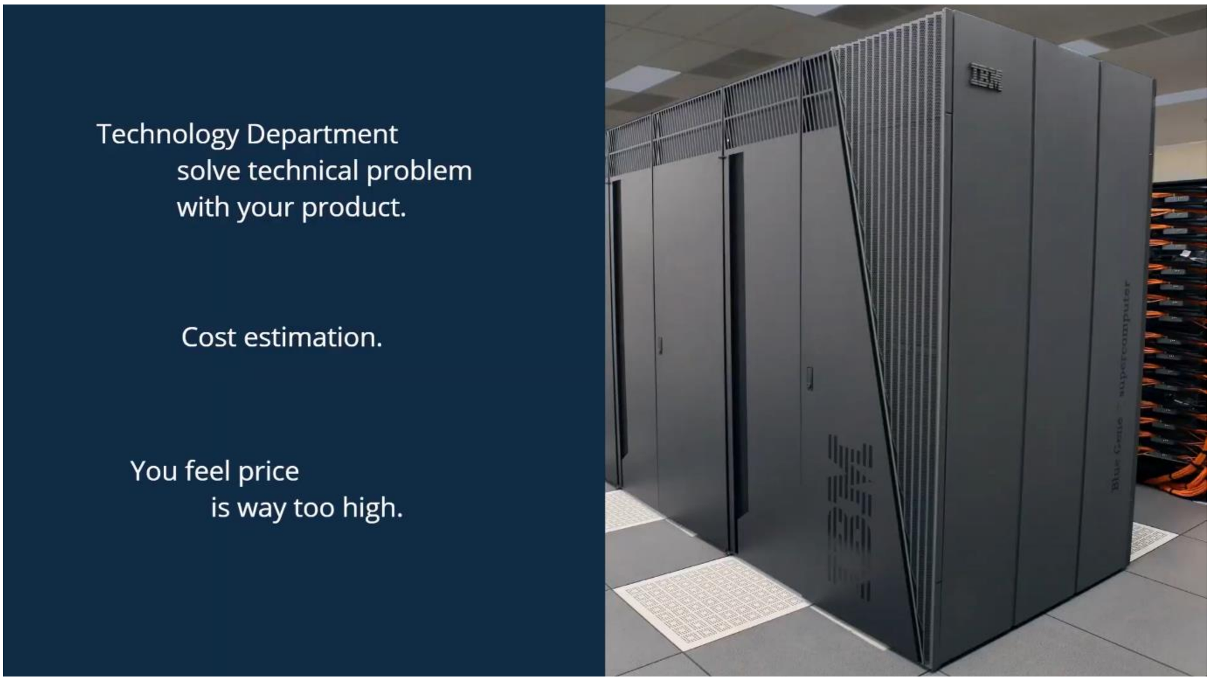


Another scenario, you offered a very competitive price for a consulting project to your client.

But your client pushed back very hard and cut the price by 25%.

You feel your client is unreasonable.

Slide #5

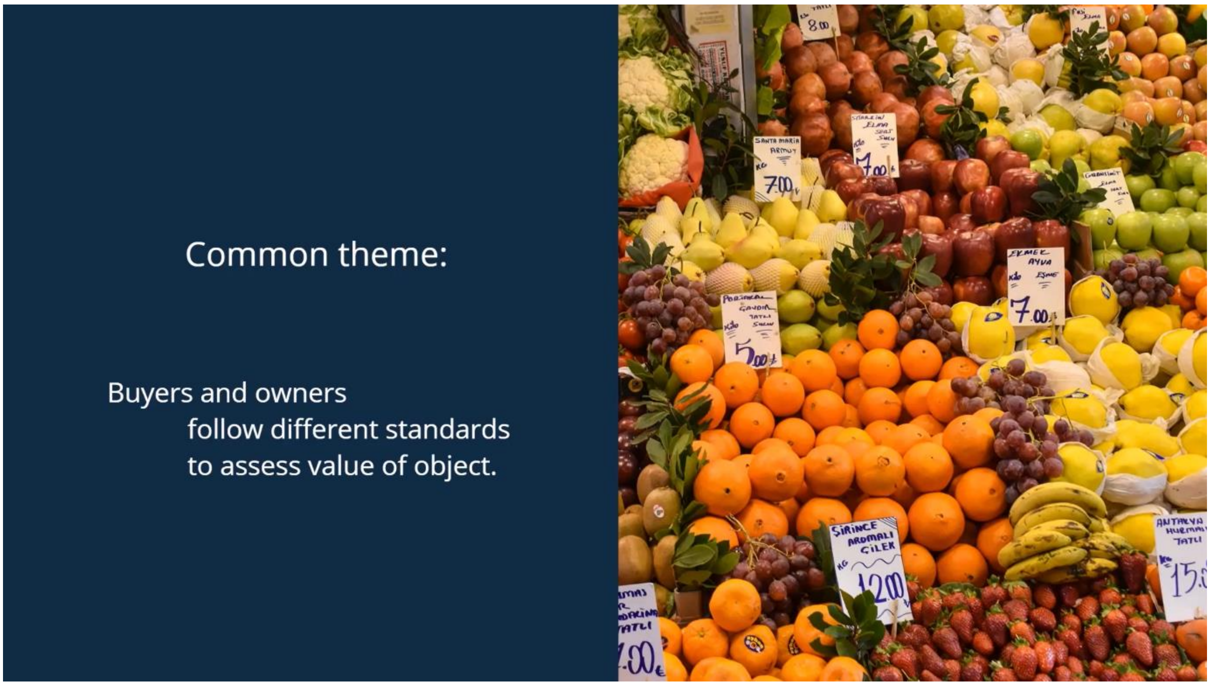


Example number three.

You are asking your technology department to help you solve a technical problem with your product.

They give you a cost estimation and you feel their price is way too high.

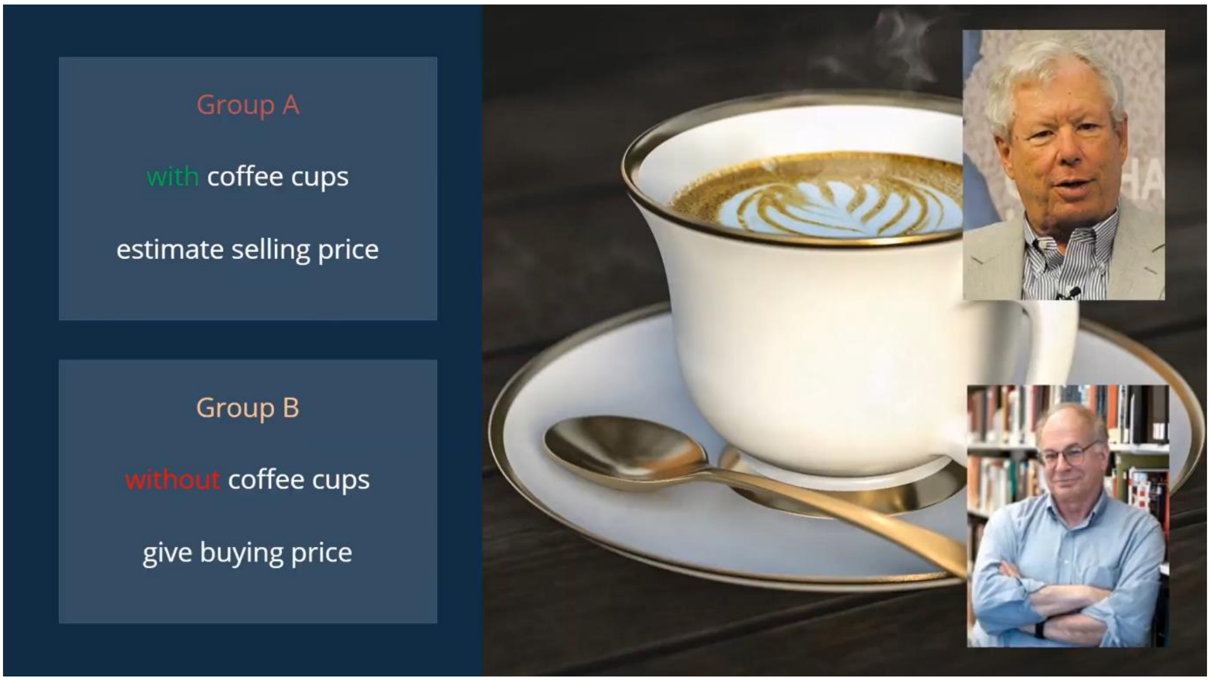
Slide #6



All of those examples share a common theme.

Buyers and owners follow different standards to assess the value of an object.

Slide #7



In the late 70s, economist Richard Thaler of the University of Chicago teamed with Daniel Kahneman to conduct a clever experiment involving Cornell undergraduate students.

The social scientists separated those students into two groups, group A and group B.

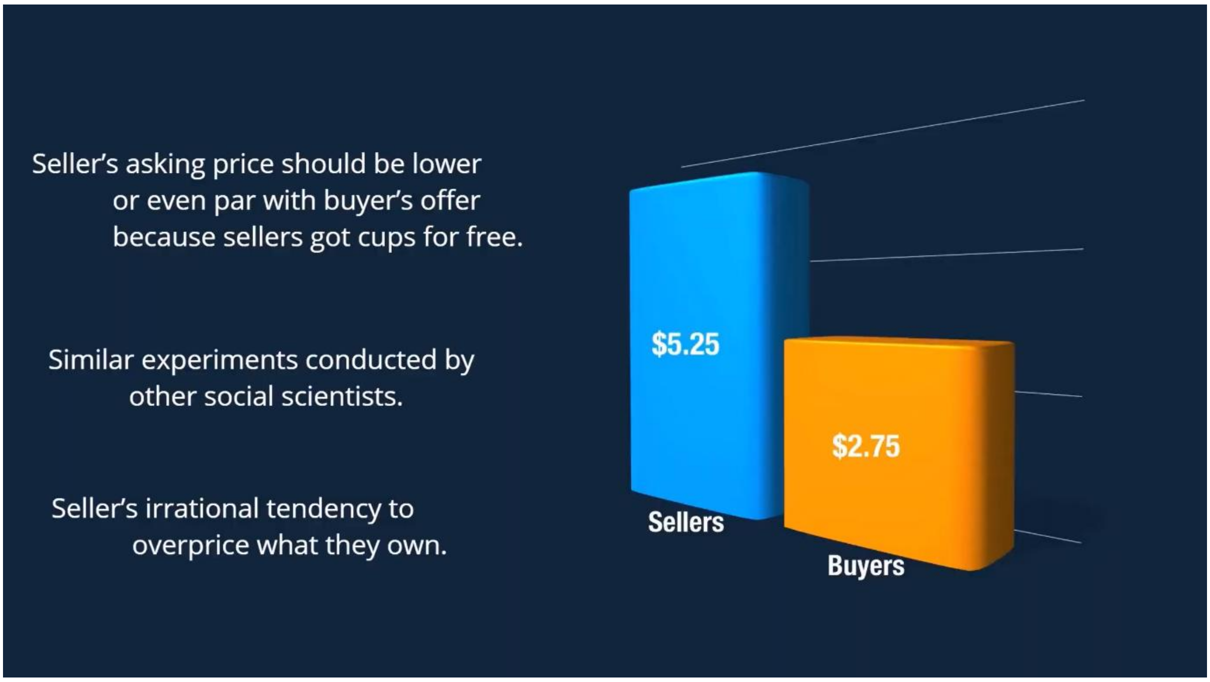
They gave each student in Group A a coffee cup, but left students in Group B empty handed.

The researchers did not tell the students what would happen next.

After a while, the researchers asked the students in Group A, the students with coffee cups, to estimate a selling price.

Then they asked Group B, the students without coffee cups, to give a buying price.

Slide #8



From the observer's perspective, the seller's asking price should be lower, or even on par with the buyer's purchase offer, because the sellers got the cups free. They did not pay for the cups.

Surprisingly, the scientists found that the seller's asking price was 5.25, and the buyer's purchase offer was half of that.

Similar experiments were conducted many times by other social scientists.

Most observe the seller's irrational tendency to overprice what they own.

Slide #11

The seller's emotional attachment to the object drives the sellers to overprice the object.

This kind of behavior is called endowment effect, and it is one of the most important behavior principles that we need to be aware of and manage when making price related decisions.

We all tend to overvalue what we own.

The value that we as sellers place on a commodity often includes not only the intrinsic value of the object, but also the value based on our attachment to the item.

However, buyers have different perspectives.

Buyers are on the objective ground.

The buyers tend to focus on the money that they are spending.

Buyers market research is biased toward the price of the commodity, and their reference price heavily influences their purchasing prices.

Slide #12

The endowment effect is very obvious in real estate transactions.

When selling a house, sellers cannot help emphasizing the improvements they have made to the house and their efforts to the custom design.

It is understandable and predictable that sellers add those experience values into the selling price of the property.

However, the buyers do not feel those items the same way.

They do not have an emotional attachment to the house. In their view, the kitchen, the pool, and the living room of the house are not different from those in any other property.

They do not value the custom design of those items.

So, the buyers always give a commodity price to the property, but sellers want the price of a custom-designed house.

Slide #13

In the business world, the endowment effect is also very common.

When we price a new product that we developed, we all have the tendency to include the experience cost into the final price offer.