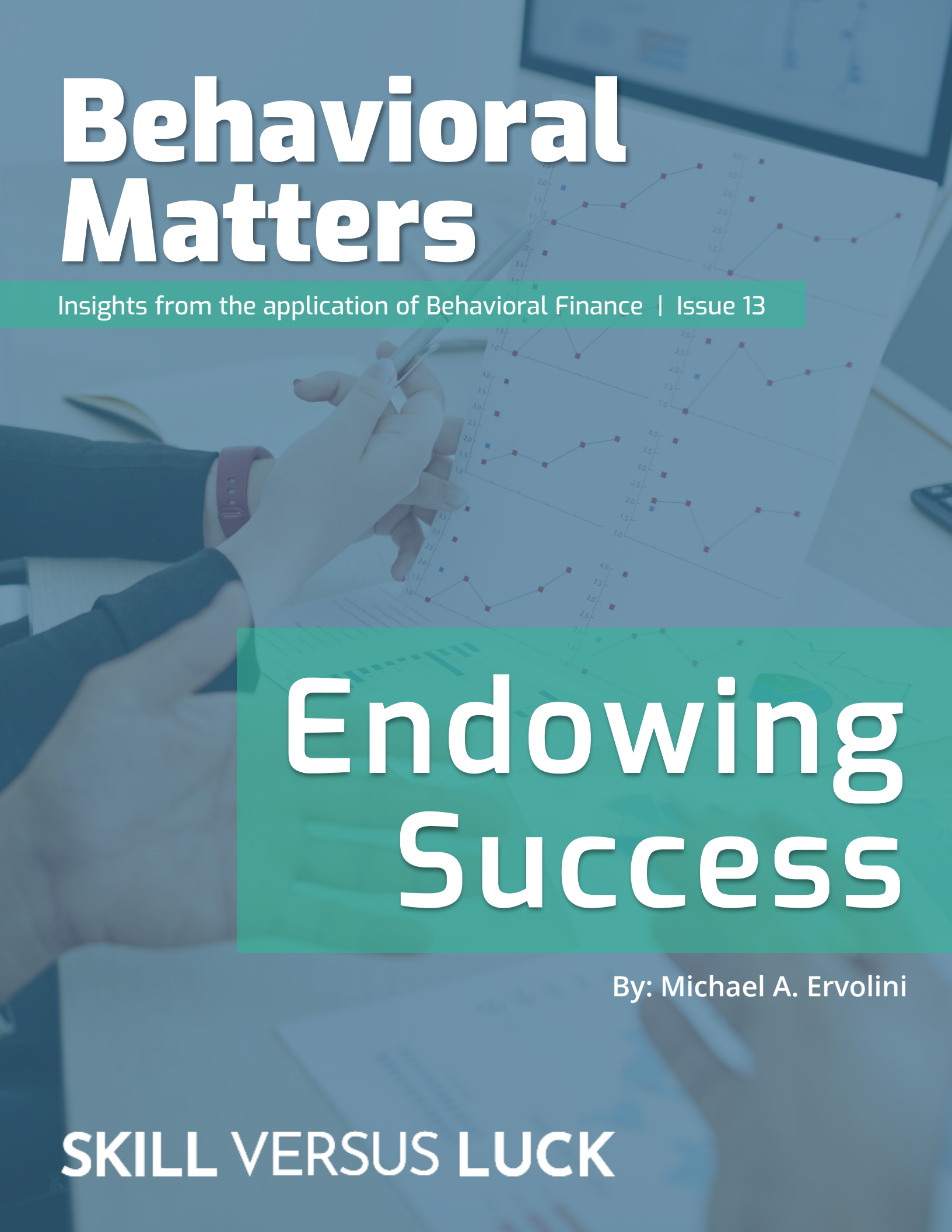


Behavioral Matters



Insights from the application of Behavioral Finance | Issue 13

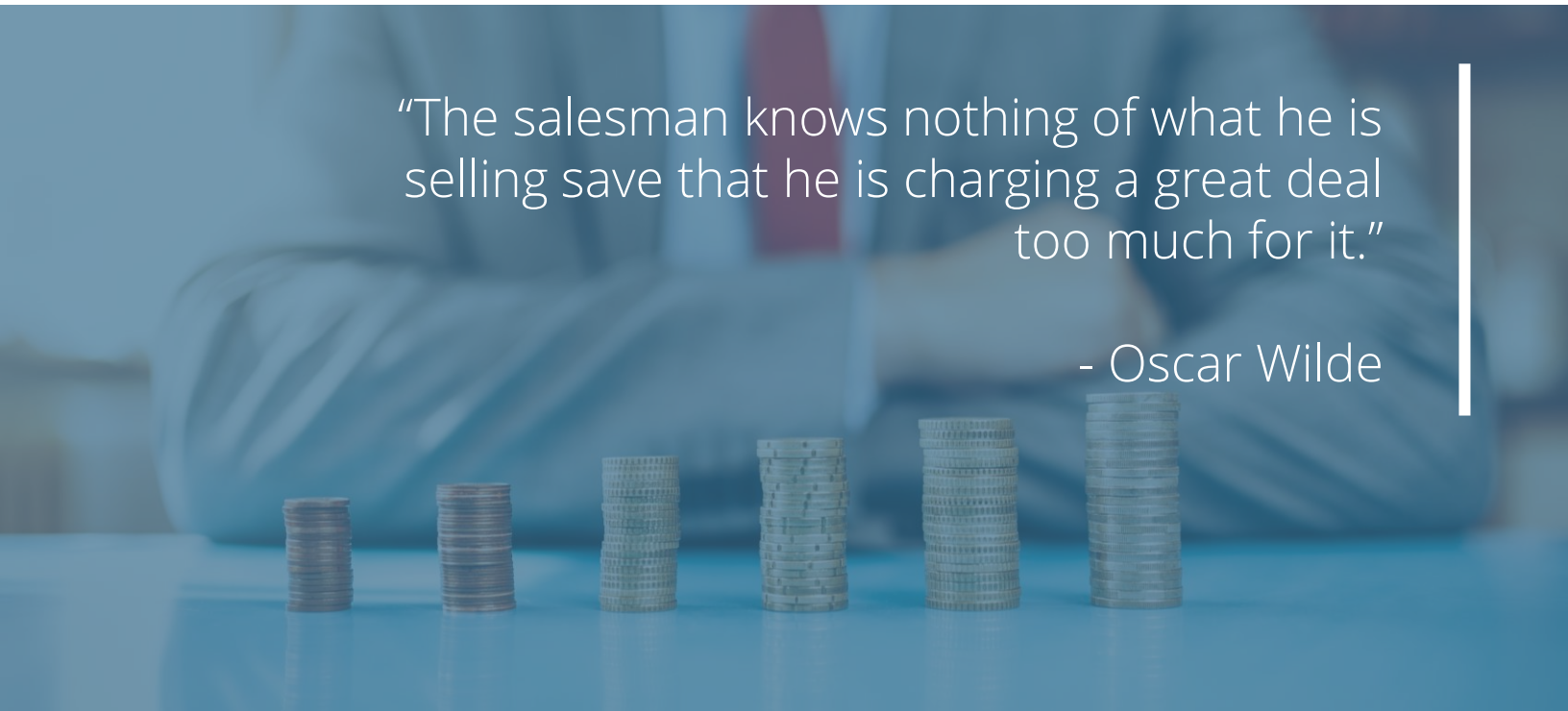
Endowing Success

By: Michael A. Ervolini

SKILL VERSUS LUCK

INTRODUCTION

Behavioral Matters is a series of essays on the application of Behavioral Finance written specifically for professional investors and portfolio managers.



"The salesman knows nothing of what he is selling save that he is charging a great deal too much for it."

- Oscar Wilde

Holding winners well past their alpha generation is a tendency recently identified among professional investors. These once highly productive buys inevitably devolve towards reversion to the mean, yet they seem to hold a special place in the minds (or is it hearts) of the managers. One explanation for holding winners too long is the Endowment Effect — valuing items higher when we possess them, making it more difficult to find a clearing price. This essay takes a look at the Endowment Effect and how it can impact the management of portfolio positions.

TRIALS OF BEING WELL ENDOWED

The Endowment Effect stifles selling. That is what Richard Thaler first suggested in 1980. The reasoning behind this theory goes like this: once a person possesses an item they then value that item more than prior to such possession. The item, it is believed, becomes part of the individual's endowment and grows in value or importance for that reason alone. In other words, you would refuse to pay the same price for an item that you would want to sell it for. At first blush this might sound like simple horse-trading — buy low and sell high. But the roots of the Endowment Effect go deeper into our psyche.

Motivating this behavior is Loss Aversion. Taking a loss is an emotionally expensive experience. Studies suggest that the displeasure of losing \$1 is two to three times greater than the pleasure of winning the same dollar. This asymmetry between winning and losing results in our avoiding losses in order to avoid the associated pain. Selling, it turns out, is perceived as a loss while buying tends to feel more like a gain. An implication of this asymmetry is that Loss Aversion will, on average, induce a higher dollar value for owners than for potential buyers, reducing the set of mutually acceptable trades.



“This asymmetry between winning and losing results in our avoiding losses in order to avoid the associated pain.”

NO MONKEYING AROUND



“The sense of attachment we feel for possessions appears to be primal.”

The sense of attachment we feel for possessions appears to be primal. Studies conducted by Keith Chen of Yale University involving Capuchin monkeys and Owen Jones at Vanderbilt University involving chimpanzees both support the notion that the Endowment Effect emanates from deep within our DNA.

The Capuchin monkeys were taught to trade coin-like tokens for food. They were offered similar amounts of food simultaneously at two windows in a specially designed pen. In any experiment, choosing one window would yield exactly the food offered, while choosing the other window would yield a 50/50 random chance of what was offered or a different amount. In one set of experiments the surprise amount was more than what was offered. In another set of experiments the surprise amount was less. After many trials, the monkeys showed a preference for choices where surprises were presented as bonuses rather than losses. They would choose the certain pay-out when they concluded the surprise was a loss; and choose the 50/50 pay-out when they concluded it provided a random gain. They exhibited classic Loss Aversion.

In a separate study chimpanzees were given a choice between peanut butter and frozen juice bars — both requiring time to fully ingest. Peanut butter was preferred by 60% of chimps when both treats were offered simultaneously. But when offered one at a time, only 20% of chimpanzees would trade. So while 40% preferred frozen juice bars, only 20% traded away their peanut butter when it was provided. Even more interestingly, while 60% showed a preference for peanut butter just 20% traded away frozen juice when it was provided. Their preferences apparently changed based on which treat they were given or possessed — a sure indication of the Endowment Effect.

THINKING IS ENDOWING

The sense of possession can be heightened merely by thinking about an item. In his 2008 paper, James Wolf discusses how exposure to an item (physical and mental) can increase feelings of ownership. He states "...that is, examining an item for longer periods of time resulted in greater attachment to the item and thus higher valuations." Does the act of reviewing portfolio positions enhance their endowment?

It certainly is possible. Research suggests that analysis can promote enhanced feelings of ownership, which then inflates the value assigned to an item, in this case an equity position. Add to this scenario a position that has hit its current price peak and the stage is set for hesitancy in selling winners. Unfortunately, learning from our mistakes is a poor approach for overcoming the Endowment Effect. Studies indicate that market exposure — that is repeated attempts at essentially the same choice — does not result in eliminating the desire to over-value possessions. In other words, being a professional is no guaranteed defense against our unconscious motivations.



86.150	+4.290%
85.400-87.200	-0.90%
82.900	-1.001%
82.300-83.300	-0.450%
112.900	-0.540%
9.900-114.800	-0.270%
83.050	-0.239%
2.900-85.150	-1.320%
19.660	-1.565%
9.480-19.880	+0.060%
6.300	+0.306%
6.240-6.390	0.000%
6.390	0.000%
6.390-6.490	+0.010%

One explanation for holding winners too long is the Endowment Effect. We become fond of what we own... to a level where our selling price floats above what reasonable buyers are willing to pay. And the more we evaluate our winners the more difficult it may become to sell them without a sense of loss. Discipline, analysis and thesis confirmation may excite that monkey inside all of us and we... well... just go bananas.

1. "How Basic Are Behavioral Biases: Evidence From Capuchin Monkey Trading Behavior", *Journal of Political Economy*, 2006, by Keith Chen, Venkat lakshminarayanan and Lauri R. Santos.
2. "Experimental Tests of the Endowment Effect and the Coase Theorem", *The Journal of Political Economy*, Vol. 98, No. 6, December 1990, by Daniel Kahneman, Jack L. Knetsch, and Richard H. Thaler.
3. "The Power of Touch: An Examination of the Effect of Duration of Physical Contact on the Valuation of Objects", *Judgment and Decision Making*, Vol. 3, No. 6, August 2008, pp. 476-482, by James R. Wolf, Hal R. Arkes and Waleed A. Muhanna.
4. "Law, Biology, and Property: A New Theory of the Endowment Effect", *William and Mary Law Review*, Vol. 49 No. 6, 2008, by Owen D. Jones and Sarah F. Brosnan.