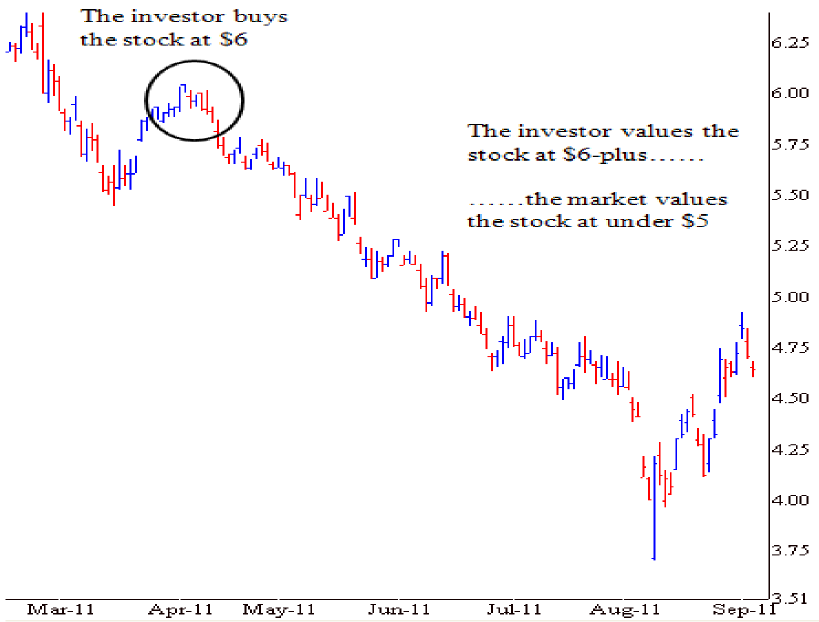
The Endowment Effect

By Paul Doggett

The Endowment Effect occurs when people value objects which they already own as being above the dollar value that they themselves would be willing to pay for it if they didn't already own it. For example, an investor who bought BHP shares for $40 will value the stock at being worth at least $50 for example, simply due to the fact that they own the stock and purchased it at $40. Privately, they wouldn't buy BHP for $50 a share themselves, but they wouldn't consider selling their own BHP shares for less than that price.

In Fig.1 we have an investor who is holding onto a losing stock which they bought at say, $6, but which is now trading at $4. He or she is unlikely to sell out of the position despite the 40% decline in value due to the endowment effect. They will withstand the pressure to sell the stock in the current market because they refuse to re-value the stock from their purchase price of $6, down to the current market price of $4. The investor engages in a mental tug of war over the value of the stock. Is it worth $6 or $4? Due to the endowment effect, they are privately convinced that it is worth at least $10 (even though they wouldn't buy it at $10 themself), but they are engaged in a battle with the market which is valuing the stock at only $4 a share. The result is that the investor continues to hold onto a losing position.

Fig. 1



It seems plausible that the endowment effect has a fundamental bearing on the 'it will come back' belief. This is the phenomena where people wait until the last minute before taking any action such as selling a falling stock back into the market because of their belief that if they wait long enough, the stock will 'come back' from its lows. We see this in June in Australia and in December in the United States because this is the last month of each countries respective financial year and many investors and traders hold onto losers in the hope that they will come back by the end of June or December so that they don't have to sell the underperforming stock as a tax loss.

Brad Odean analysed a database in the United States with thousands of investments and found that the disposition effect was present throughout the year, except during December. In December he witnessed a significant increase in the rate of loss making trades and investments sold back into the market and concluded that investors and traders did so to realise the physical losses[1].

Due to the 'it will come back' belief many investors give their loss making investments as much time as possible to 'come back' to a better value, before they simply have no other choice but to book the physical loss, generally at the end of the financial year. The mental trader who is aware of this sort of detrimental operational method can take steps to avoid falling for the endowment and loss aversion effects and can take losses early and make whatever money is left, start working for them again in the market instead of languishing in their portfolios, dragging down their overall portfolio return until either June or December comes round.

Studies have also shown that investors are very tempted to repurchase a stock which they have sold if that stock is trading at a lower price than what they sold it. Perhaps they do it because they feel like they are now getting a real bargain. They are also less likely to repurchase a stock which they have previously sold (see Fig. 2), if it is now trading at a higher price than the price at which they sold it. It is definitely a by-product of the endowment effect.

Fig. 2

[1] Odean, T., 1998, Are Investors Reluctant to Realize Their Losses? Journal of Finance, 53, 1775 – 1798.

Accept the value that the market places on a stock on a daily, weekly or monthly basis and make a point of not fighting the market over the value you place on a stock and the value the market places on it.