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Loss Aversion: The Irrational investor Attitude

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ABSTRACT

Loss aversion attitude is one of the most studied and renowned topic in the field of behavioural finance. It has been considered as an built in human instinct which directly affects their decision making process. Many empirical studies have also been conducted on loss aversion. Some studies have also showed some other concepts like endowment effect, status quo bias, etc complementary to the loss aversion study. However review of earlier studies shown that although studies are available for complementary concepts for studying loss aversion behaviour but a paper covering most of the concepts together is not available. So in this paper, which is basically conceptual and descriptive in nature has attempted to simplify the concept of loss aversion and to identify the situations which can reflect either directly or indirectly the presence of loss aversion attitude in decision making.

KEYWORDS : Loss Aversion, Behavioural Finance, Endowment effect

Introduction:

The study of investment behaviour particularly in the securities market has developed many theories till date. Efficient Market Concept was also one such important development in the line. Earlier the investors were thought to be rational while making investment decisions as said by the Efficient Market Concept. But different studies have shown the faulty picture of the assumptions of efficient market concept. No doubt the efficient market theory is one of the leading theories of finance still today and it is due to the analysis of this theory itself that has contributed to the development of new areas of study. "The efficient market hypothesis became one of the most influential concepts of modern economics and a cornerstone of financial economics. It was extended in many directions, and literally thousands of papers were written about it." [Alajbeg Denis et al., 2012]. But this critical and in depth analysis of the theory is important so as to better study the investor behaviour. One of such area which has evolved mainly during late 90s and has challenged the assumptions of market efficiency concept is the Behavioural Finance. "The Efficient Market Hypothesis is considered as the backbone of contemporary financial theory and has been the dominant investing theory for more than 30 years (from the early 60s to the mid 90s). "Needless to say, a generation ago, it was the most widely accepted approach by academic financial economists" [Konstantinidis et al., 2012]. The study of human behaviour was originally studied by a separate discipline, i.e. Psychology. But Behavioural Finance is actually an inter-disciplinary approach which borrowed the psychological theories of human behaviour into the field of finance. And later on the concepts of human behaviour from different other disciplines, like sociology, neuro-science were also used by this branch of study. Behavioural finance says that human beings can never get rid of emotions and the situation of making investment decisions is also not an exception to it. "Efficient market concept deals with the information and how the informational accuracy affects the stock market. But the behavioural finance dimensions deal with the market participants' behaviour not only on the basis of information but also several other emotional and psychological dimensions. It is the behaviour of the market participants which shapes the ultimate stock market structure. So an in depth study of the behaviour is felt necessary and this job is undertaken by the behavioural finance discipline."[Amlan J.Sharma, 2014].So as the efficient market concept said about human beings of being always rational in making investment decisions has been challenged by the field of behavioural finance on the ground of presence of different psychological and emotional biases. One of such investment bias is the "Loss Aversion". In this paper an attempt has been made to analyse the meaning and concept of loss aversion bias, features of loss aversion bias and the indicators of presence of loss aversion attitude in investment decisions in a simplified way.

Purpose of the Study:

This study has been conducted mainly to simplify the concept of loss aversion attitude of the investors, which is one of the investment biases identified by the behavioural finance discipline with regard to study of investment behaviour of individuals. The paper first discusses the meaning and concept of loss aversion and followed by the features of loss aversion attitude and then identifying the factors implying the presence of loss aversion attitude in making investment decisions.

Methodology of Study:

The paper is mainly conceptual and descriptive in nature and it is based on the studies available over internet based sources and various other related books and journals.

Theory of loss aversion:

Aversion means the feeling of dislike or disinclination and loss aversion means disliking or feeling uncomfortable about a loss. This psychological feeling was first proposed by Kahneman and Tversky (1979) in their famous prospect theory. Tversky (1991) further used this concept in his study about making decisions under certainty. To date many scholars have studied the effect of loss aversion on decision making under different situations. As stated by Kahneman and Tversky, people are generally loss averse or to put in other words they are more sensitive to losses than same amount of gains. They put more weight on losses than gains, e.g. investors are more affected by a Rs.100 loss than a gain of Rs. 100. When an investor faces a loss, his mind becomes more disrupt and his mindset doesn't try to accept the loss and instead try to reduce the feeling of discomfort by taking every possible step and at times even knowingly or unknowingly takes more risk in the whole process. This is an interesting aspect of irrational behaviour by investors. Loss aversion arises because we have a fear of losing our money invested even if it is not possible to recover the loss; we try to have a position where the recovery seems possible even if it is impossible in reality. For example even if the price of our old good stock falling deeply now, we don't want to sell it with the hope that it will reverse back to its original good position in future, although this future is far distant. In a nutshell we cannot afford to bear a loss. Another side of the concept is that loss is more influential than profits,.e.g. if the price of our good stock falls by Rs100, it will make us more concerned than if the price rises by Rs. 100.

Discussion:

As cited above the theory of loss aversion was first developed by Kahneman and Tversky (1979) and they further adjusted and added new dimensions to their concept in next years which can be seen from their further studies entitled "Loss Aversion in Riskless Choice: A Reference-Dependent Model (1991)", "Advances in Prospect Theory: Cumulative Representation of Uncertainty (1992)", etc. They found that if subjects were to choose between two alternatives, viz. one with high risk of loss with higher gain and one with lower risk of loss with lower gain, they were more likely to choose the alternative two i.e. less risk of loss even with a lower expected return than the greater risk of potential loss and a higher gain. It implies that people are loss averse in nature and even they like to forego gains at the cost of loss expectations. They also found that to make the subjects attracted to the alternative one the extent of gain should be twice higher than the potential loss.

Along with them different other scholars too studied about the theory of loss aversion and many of them supported the view of Kahneman, et al. and some others found contradictory findings too.

In Thaler et al. (1997) study of investment portfolios, they found that participants preferred to invest in a lower risk fund (mean return of 0.25%) in which returns were all positive rather than a fund with a mean expected return of 1% which produced occasional losses.

Scott Rick (2010) concluded that individuals treat losses as if they were more impactful than comparable gains but loss averse decisions alone cannot clearly reveal whether losses are actually experienced more intensely than comparable gains. They argued that more research is needed in to the causes of loss aversion behaviour.

Sabrina M. Tom, et al.(2006) made an experimental research to find out the impact of brain system on loss aversion behaviour and they concluded that cognitive account alone does not explain why losses should loom larger than gains, rather the phenomena should be associated with the increased activity in brain systems involved in negative emotions. At the end of their study they surprisingly found that, greater loss aversion was associated with greater sensitivity to both not only losses but also gains. Thus it has been revealed from the literature that there is a presence of loss aversion attitude in investment behaviours in one form or the other.

J.P. Ropo,(2014) in his study about presence of loss aversion in small stake decisions found that loss aversion is not a stable construct . He concluded that loss aversion is less in small stake decisions as compared to high stake deciaions.

Thomas A. Stephens and Jean-Robert Tyran(2012), in a discussion paper mentioned that people place more weight on nominal values than the real values. They concluded that Transactions involving real gains are viewed more favorably, as they should be, but gaining more money without an increase in the real gain has little impact on evaluations.

A. Peter McGraw (2010), et al. in their research experiment concluded that loss aversion in gain-loss situation is not same as in situations of comparison not made in context of similar outcomes, e.g. gain and gain comparison. "The question of whether or not there is loss aversion in judged feelings is thus in part a question about the context of judgment. If gains and losses are considered together in the same context, then the asymmetry follows."

Mengarelli F, (2014), et al. in their research article has made a comparative study about presence of loss aversion in decisions made for self and for others. They opined "when deciding on others' behalf, participants become more risk-seeking as compared to when deciding for themselves. This finding corroborates the hypothesis suggesting that economic decisions are perceived less riskier and loss aversion is minimized when economic consequences involve other people".

Ert, E., & Erev, I. (2013), "the exact effect of losses does not result from a stable perceptual construct: losses do not always loom larger than gains" Thus they rejected the assertion that people exhibit stronger risk aversion in choices that involve possible gains and losses than in choices that involve only gains.

Brenner Lyle, et al (2007) stated in their paper "Loss aversion has also been used to explain how and why riskless choices may depend on a consumer's initial position.."They also said that the reluctance to trade seen in the endowment effect and status quo bias can be explained in terms of the differential sensitivity to losses and gains predicted by loss aversion.

Thaler,R(1980), Ariely D. et al(2005) stated that the loss aversion puzzles can better be explained by using endowment effect study.

Factors signifying presence of loss aversion attitude:

Based on the review of literature the following factors or concepts have been identified as reflective or complementary to the presence of loss aversion attitude in decision making process of individual(s).

Framing Effect: This concept is based on the decision frames. As per this theory the answer (the decision) to a question (situations) depends on how the question has been framed. If the framing of the question is changed the answer does change. From loss aversion point of view the framing effect is based on two decision frames, either gain or loss. It implies that the influence on decisions when the prospective loss is more stressed will be more than when the gain is more stressed. As L. Jack S.(1996) commented on Prospect Theory that framing of the problem around a reference point does influence the choices and that people tend to overweight losses with respect to comparable gains, to be risk-averse with respect to gains and risk seekers with respect to losses.

Endowment Effect: This theory says that human beings value an item more when it is in his own possession rather than when he is not the owner of the item. For example, if someone has got a share of a company, and he wants Rs. 500 to sell it of, but if he does not have that share and he wants to buy it then he may not be interested to pay Rs.500 for the share or that he would like to pay less than Rs. 500. It indirectly implies the presence of loss aversion attitude in the sense that he feels more pain to lose something he already possess but to gain that possession he may not have same amount of happiness. Loosing something looms larger than gaining the same thing i.e. looses overweigh the gains. Dean Mark et al. (2014) found strong evidence that loss aversion in risky choices were predictive of the endowment effect.

Status Quo Bias: It may be said to be an alternative version of endowment effect theory and implies that people generally like to be in his current position of holding assets and are not generally interested to part with the current holdings. They have a tendency or that they feel a pain to part with their original holdings. They just want to avoid a change due to the risk inherent in a change. The risk is of an anticipated loss. As pointed out by E.Zamir and I.Ritov (2012) "since losses loom larger than gains, people are inclined to avoid departing from the status quo although by doing so it may result in either losses or gains." Thus a Change with a slight risk may bring more gains too, but the element of that little loss prohibits accepting the change i.e. a slight risk of loss is valued more than a bigger gain, which is the key concept of loss aversion. As mentioned by C. Alexander, (2004) that considering the status quo option as the reference point, individuals overweighs potential losses likely to arise from choosing an alternative which is away from this reference point than the potential gains, and this directs him to choose the status quo alternative. Due to the status quo bias investors tend to choose the same alternative which they previously had and don't want to take even slight risks by going for new alternative even if prospective gains are more.

Conclusion:

To sum up it can be said that loss aversion although studied many times and at different situations, but more studies along with those complementary concepts mentioned in this paper should also be made to enrich the original concept of loss aversion. And at the same time loss aversion studies as pointed out in some papers regarding situations where gain/loss cannot be measured in monetary terms should also be encouraged.

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