LOSS AVERSION

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Contents

INTRODUCTION

- *"Death is not the greatest loss in life. The greatest loss is what dies inside us while we live."* ~Norman Cousins
- Daniel Kahneman and Amos Tversky demonstrated the concept of Loss Aversion for the first time. Loss aversion defines people's preference of avoiding losses and acquiring gains.
- The concept of Loss aversion explains that how much people are afraid of incurring losses. It is a human characteristic. When people compare losses and gain, it is seen that people dislike losing much more than winning. Hence, losses affect more than gains despite being the identical value in monetary terms.

IMPACT OF LOSS AVERSION

- The immediate impact of Loss aversion is risk aversion. It also leads to various behaviours which are predictable in certain **si**tuations:
  - **Dangerous to lifestyle**
  - **Losers and Winners**
  - **Poor choices**
  - **Ownership and its Power**
  - **Status Quo Bias**

RISK ATTITUDE AND LOSS AVERSION

- When people have to take decisions under uncertainty, two biases which affect them are:
  - **Possibility Effect -** This effect gives more weight to highly unlikely events than they justify.
  - **Certainty Effect -** This effect gives less weight to events that are almost certain than what is actually justified. Due to loss aversion, people want to eliminate risk rather than reduce it.

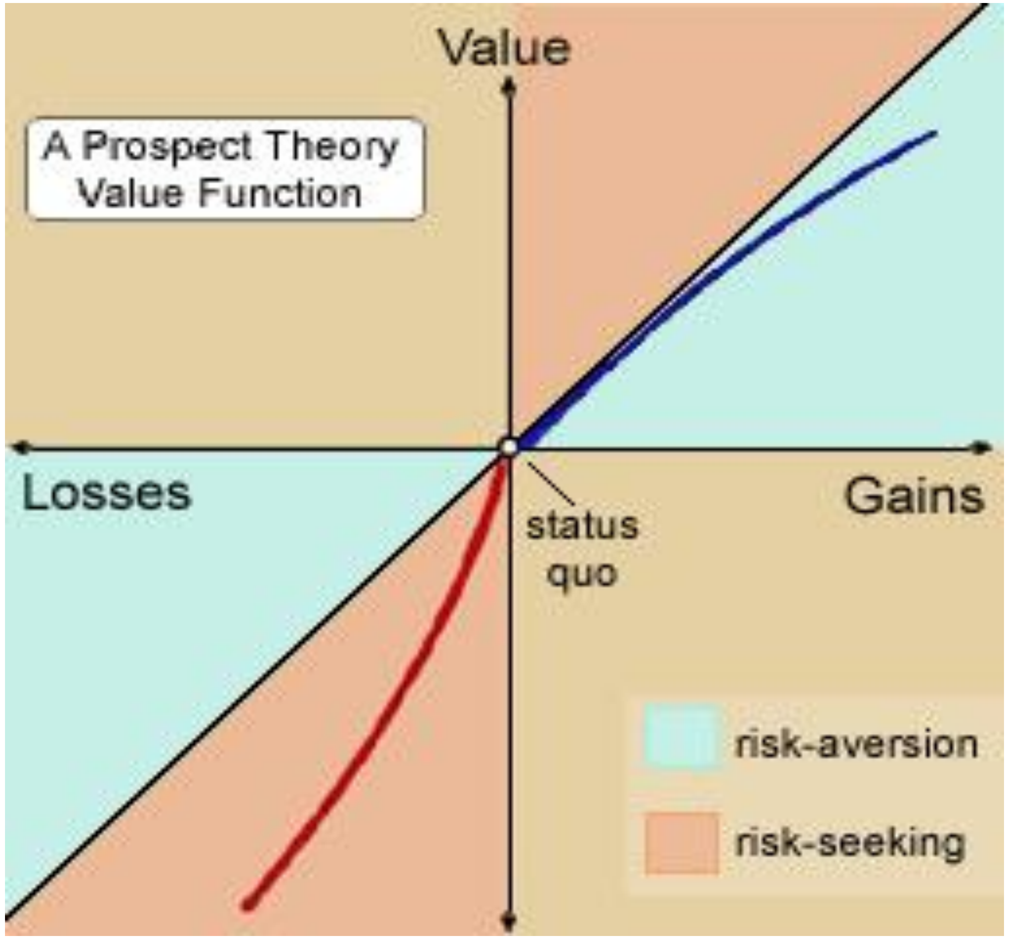
BASIC PREMISE OF LOSS AVERSION

- Loss aversion refers to the strong preference to avoid losses when compared with the desire for gains. In other words, it refers to feeling more unhappy due to losing 10 bucks, than feeling happy from gaining 10 bucks.
- Irrational decisions are made by us everyday to avoid losing. At times we are not sure that what will be the returns of any action, but fear of losing something good motivates our actions.
- Economists have identified loss aversion as key decision making factor. Mostly people take any action as they want to avoid losing money as compared to acquiring more. Psychologically, people feel that impact of losing is twice as powerful as the pleasure of gaining something.

STEPS TO OVERCOME FEAR OF LOSS

- **Question to ask yourself, “What am I scared of losing?”**
- **Try to see the whole picture**
- **Loss aversion can be used as motivation to follow what is really wanted**
- **Motivations and intentions need to be assessed regularly**
- **Changing the way one sees that the loss is inevitable**

MODEL AND TYPES OF LOSS AVERSION



Prospect Theory

"We have an irrational tendency to be less willing to gamble with profits than with losses."

In prospect theory three features are talked about,

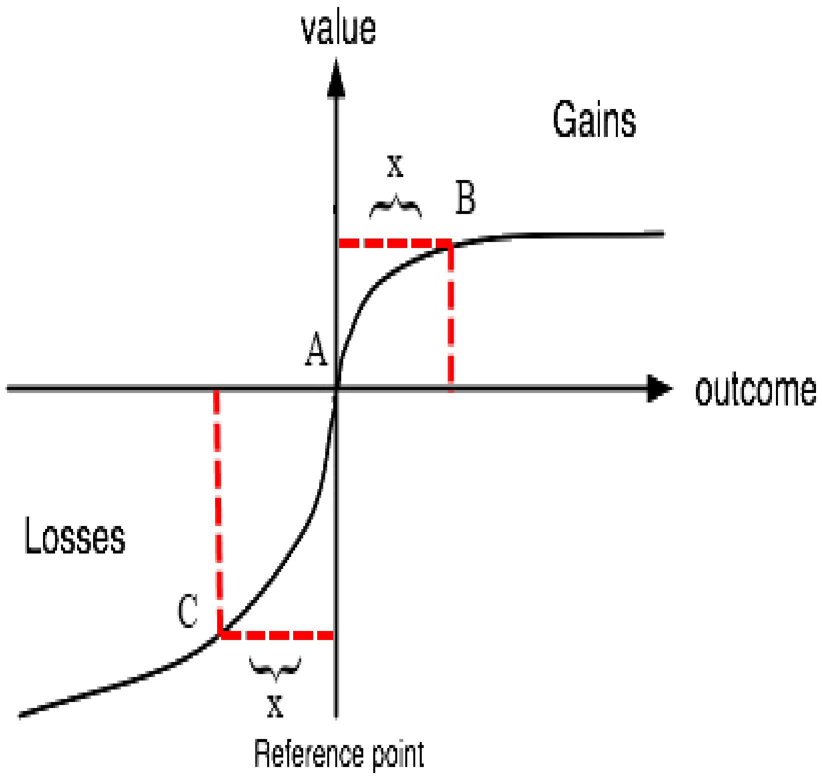
- **Reference level dependence**
- **Gain and loss satiation**
- **Loss aversion**

MODEL AND TYPES OF LOSS AVERSION (Cont.)

ENDOWMENT EFFECT	CONNECTION BASED THEORIES	**MYOPIC LOSS AVERSION**
• The endowment effect allows people to value things more which they possess as compared to others which they do not have. • In behavioural economics, the endowment effect provides hypothesis that people put more value to things just because they are the owners. Endowment effect is also known as divestiture aversion.	• Connection based theories suggest that the subjective feeling or connect one has with some object defines people’s behaviour of not ready to trade it.	• Benartzi and Thaler define that myopic loss aversion combines one’s high degree of sensitivity towards losses and attitude to frequently evaluate one’s wealth.

REFERENCE DEPENDENCE MODEL

- In reference dependence model people refer to their status quo or reference point to make a decision of choosing an alternative or not. Another assumption of this model is that losses have greater impact on preferences than gains, thus we can see deformation of indifference curve about a reference point.



FRAMING EFFECT AND LOSS AVERSION

- People experience losses very differently from gains as shown in the previous studies. People feel double the pain as compared to pleasure with a gain. Hence, people tend to be loss averse which affects their decision making.

For example:

A mayor of a small town having population of 600 people has to take a decision. There is an epidemic spread in the town. There are two solutions available. The first solution guarantees saving 200 people. The second program can save all 600 people with one-third probability. Which one would you choose?

Like most of the people one would choose the first program. As it would be a sure thing over a risky gamble.

Thank You

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  GAMBLER FALLACY

  Continued…