THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

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Possessed by your Possessions

"Once you make an investment, you can't help regarding it as yours. You have invested part of yourself in it. The word 'Invest' literally means to 'to clothe' yourself in something (from Latin). When you buy a stock, you wrap it around yourself, and it becomes a part of you."

– Jason Zweig, Your Money and Your Brain

In the book "Misbehaving", Richard Thaler talks about a colleague of his from the Economics Department, who was a Wine Collector since a long time. The colleague had, in his cellar, wines that he had bought at USD 10 a bottle many years ago, and the current market price of some of those would be approximately USD 100. He enjoyed those wines on special occasions but would not think of buying them at the current prices. Infact, he had received a bid from the local wine seller to buy some of his wines at the current market price. The colleague had however, declined to sell the bottles.

Thaler found this illogical. If the joy of having these wines was worth more than USD 100 (since the bid was turned down), then why the hesitation in buying the wines at USD 100? Why is one willing to neither buy wine at a higher price nor sell it at the same higher price. Thaler explored it further along with Daniel Kahnemann and Jack Knetsch in an experiment involving university students. They got mugs with the university insignia printed on them and got a market organized to trade them. They got a group of students together and distributed the mugs randomly to half of them. The students were allowed to trade the mugs for money. However, hardly any trades occurred. To understand why, the students who didn't have the mugs (buyers) were asked what price they would like to pay to get a mug. The average prices they were willing to pay was USD 2.75. When the

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sellers (who had the mugs) were asked what price they would accept to give up their mugs, they demanded over double the price at USD 5.75.

In several rounds of these experiments, researchers found similar results. Most of the people quote two different prices for the same object; one, that they are willing to pay to acquire it in case they don't have it and the other, much higher price that they demand to give it up once it is in their possession. Richard thaler coined the term **'Endowment Effect'** for this bias.

(A note for some readers who have a philosophical bent of mind like me and feel normally people take things they have for granted and undervalue them. This is a different situation where you are made to imagine that you part with it and what compensation will you take for losing that thing).

ENDOWMENT EFFECT IN INVESTING

A lot is written in the investing world about the ills of high trading frequency or churn in the portfolio. However, the other side of the equation also has some downside. This is inertia or status quo bias caused by the endowment effect. In investing too, people prefer to stick to what they currently own or inherit or are endowed with. They value it much higher than market prices of their investments. This certainly does help in long term investing. It brings to our minds, images of stocks that have created wealth for shareholders over the decades. However, there are also nightmares of losses suffered by investors who were not willing to act when it was in their interest to do so.

Readers of my notes know that I don't support trading or churning the portfolio at short intervals. Infact, I advocate having a good buy and sell discipline as discussed in my previous note here. But resistance to change when the situation warrants it, is harmful. Specially, the resistance caused by a strong anchoring bias on our current position.

Once an investor has allocated capital in the portfolio to an asset or a security and suppose then she is immediately met with an argument

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against that position, endowment effect will cause resistance to act on that development. Loss aversion is an important cause of endowment effect where an investor doesn't want to exit a position which is lower than the purchase price. Loss of a certain amount causes pain which is almost twice the amount of happiness caused by the gain of the same amount. Even in investments where the investor is making a profit, the reference point for mental accounting may have changed to the 52-week high price or the all-time high price or valuation. Selling below that level may not be acceptable to the investor.

THE EVIDENCE IN THE IPO MARKET

The standard economic theory assumes that subject's valuation of an asset is unaffected by the ownership. Santosh Anagol, Vimal Balasubramaniam and Tarun Ramadorai studied whether this is really true through an experiment in the Indian IPO market. When an IPO is highly oversubscribed, the retail investors who have applied for the IPO are allotted shares based on the randomized (lottery) system. The winners get a minimum number of shares allotted to them and the losers get their money back in their bank accounts. Both winners (who got only a small quantity) and Losers (the investors who were not allotted the shares) can buy the equity shares from the market when the company is listed.

Researchers found strong evidence of the endowment effect. They found that winners of IPO lotteries were substantially more likely to hold the randomly allocated IPO shares for many months and even years after the allocation. The losers hardly owned any stock immediately after the listing irrespective of the opening price. There was some increase in shareholding from loser in the next 24 months but much lower than winners. Also, the propensity of winners to actively purchase additional shares of the IPO stock was higher than the propensity of losers to purchase the IPO stock at all.

THE IKEA EFFECT

Working hard (or being committed) on a something (to someone) also gives us the feeling of ownership (you get it!). Researchers Dan Ariely and Mike Norton call it the Ikea Effect! Ikea as you all know is a

Swedish retailer which sells many items of furniture that requires assembly. Ariely and Norton found that consumers assign higher value to products that they assembled on their own than their readymade alternatives. The same is true when an investor or an analyst puts a lot of work in working on asset or security valuation.

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I run an experiment to ask industry analysts to have a look at my portfolio holdings and give their view by bucketing the stocks into 4 categories: a. Buy (to be added now) b. Buy at a certain lower price c. Sell (to be sold immediately) d. Sell at a certain higher price. The findings always lead to interesting discussions. While Buy and Sell are committed and announced recommendations and most likely going the analyst way, the two other categories show endowment effect. Category B is usually the company that analysts like, but they had missed recommending or owning earlier. They hence don't want to pay the current price and want to give a lower price (the same as mugs). Category D generally has stocks that the analysts have recommended or owned but have not performed well. They analyst want to sell them, but they still feel ownership effect and want a higher price than the market is providing.

OTHER AREAS OF ENDOWMENT EFFECT

There are other aspects of investments where endowment effect or ownership impact on valuation can be spotted:

The Hold Zone: Imagine you are owning an asset and the price has moved up. You don't want to add to the position; you don't want to sell it either as you are hopeful that someone else will surely buy it at even higher price. The gap between your buy price and the sell price is the Hold zone and possibly the endowment effect.

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Dual roles: In some asset management companies, there is a dual role given to individuals; they act as portfolio managers for a fund as well as support the team as an analyst on a sector. The recommendation to colleagues on the sector that one is tracking are likely to be influenced by the position is one's fund. A mistake in the portfolio can still continue to be on the recommendation list for other portfolios due to loss aversion or endowment effect.

A similar problem can be encountered with financial consultants running a Portfolio Management Service and an Advisory service under common management. There is a chance that the recommendation to clients will be influenced by ownership in the PMS portfolio.

INHERITING A PORTFOLIO

Imagine two scenarios:

1. You have been given a portfolio of 30 securities worth Rs. 10 million and you are supposed to manage it as you think correct to generate a certain return
2. You have been given cash of Rs. 10 million and you are supposed to make a portfolio of securities and manage to generate a certain return.

Typically, one has an easier time in the scenario 2. One can make a model portfolio and deploy the funds. In the scenario 1, it is difficult to completely change the entire portfolio to a model portfolio without evaluating the current holdings. As you work on it, the endowment effect comes in.

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How does one manage this bias? Try to evaluate every position or decision taken from a fresh perspective. If you were deploying funds today, how would you do it? would you have the same securities? The idea is not to continuously change the stance, but to be conscious of biases that can creep in. in one of my previous notes I had mentioned that the new BUY + HOLD = BUY + WATCH – TRADE. Create a good buy – sell discipline and follow the plan!

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HEAD – INVESTMENTS, EQUITIES

CANARA ROBECO

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).