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Why stocks that you hold look so much better than all else, Devina Mehra explains

The Endowment Effect is insidious and a core part of our being, The only way to overcome it is with a rigid set process of looking at your portfolio from scratch every quarter or at least annually— preferably with another independent set of eyes.

DEVINA MEHRA | MAY 31, 2021 / 11:18 AM IST

An American university did an experiment where it gave a set of students a coffee mug. A few days later, the same coffee mug was offered for purchase to other students. The ones who had to buy it, valued it at around $3 on average but the students who had the mug were not willing to sell it for less than $6-7. This is a classic example of the Endowment Effect or the Endowment Bias.

Other examples of the Endowment Effect include experiments which found that participants' hypothetical selling price for a ticket to a big sporting event was 14 times higher than their hypothetical buying price.

It has been found, in multiple experiments, that people's maximum willingness to pay to acquire an object is typically lower than the least amount they are willing to accept to give up that same object when they own it—even when there is no cause for attachment, or even if the item was only obtained minutes ago.

This attachment or the tendency to overvalue what you own only becomes stronger when you have inherited an object or owned it for a long time.

This, in short, is the Endowment Effect or bias: when you value something more simply because you own it. It has been observed time and time again. For example, you bought a bottle of wine for say Rs 800 but if someone wants to purchase it, you won't sell it for less than Rs 1,100 or even more.

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And like most things that are common across human beings, this is not a recent trait. Thousands of years ago, Aristotle wrote: "For most things are differently valued by those who have them and by those who wish to get them: what belongs to us, and what we give away, always seems very precious to us."

Too close to be objective

And the Endowment Effect makes an appearance pretty early in our life. A three-year-old will guard her favourite toy, even if you promise to replace it with a replica.

Neuroscience shows that when we look at objects owned by us, the parts of the brain dealing with our self light up. We closely identify with what we own, almost as if it is a part of us.

In traditional economic and finance theory, humans are supposed to be strictly rational creatures but in real life, a whole lot of studies have shown that our behaviour is anything but rational.

Behavioural economists and behavioural finance scholars explain such allegedly irrational behaviour as a result of some sort of cognitive bias that warps the individual's thinking. This is the second piece in my series on these Cognitive/ Investing biases. The first one looked at **why were are hardwired to make wrong investment decisions.**

In investing terms, the Endowment Effect means that once you hold an asset or investment, your evaluation of it is no longer objective or rational.

Let us say you are capable of analysing and valuing stocks. If it is a stock you do not own, you will be better able to make an objective assessment about it but if you own it, you will always feel that it has a higher value without being conscious of it.

If you didn't hold that stock, you may have thought after your valuation exercise that a PE multiple of 18-20 times was justifiable but if you hold that stock, you may feel that the PE of 25 or 30 is also justified. You may continue to hold that stock even when it goes beyond your rational valuation threshold.

This bias can affect attitudes towards assets owned over a long period or even crop up immediately—as soon as the asset is acquired.

Why 'hold'?

Going back to the earlier examples, when we get attached to even mundane objects like coffee mugs or a bottle of wine, securities or other investments we hold are much closer to our hearts because firstly, they are more closely aligned with our well-being.

Secondly, investing in a stock or other asset means that you have analysed the options and made a conscious choice. Now you do not want to change your mind because you do not want to think that your earlier choice was incorrect. Hence, you are likely to be even more invested mentally (pun intended) in a stock that you own than in other daily-use objects.

That is why most people will keep defending the stocks that are in their portfolio and hold on to them for too long.

In fact, the Endowment Bias is the single reason why a “Hold” rating exists in the lexicon of market analysts.

Think about it, if a security is not worth buying today, why is it worth holding? The whole construct of having a “hold” rating is to hide from us the fact that we are being irrational by putting a covert premium on something precisely because we are already holding it.

You may even kid yourself that you are holding on to this investment because you do not want to incur unnecessary transaction costs but the fact is often that investment may not make sense even if you net out the transaction cost involved.

In fact, usually the transaction cost of a switch in investments is negligible compared to the potential loss of holding onto the wrong investment or the potential profit forgone for not making a switch to the right asset.

Other factors involved may be just a comfort factor with something familiar or a decision paralysis that leaves your portfolio unchanged for long periods because you want an irrational premium to sell something you hold.

The problem is such rationalisations can be detrimental to your financial health because of the failure to take the required action.

Since you now know that this is a bias, you need to guard yourself against it. The only real way to make a start is a zero-base portfolio approach. Do not think that how can I sell Hindustan Unilever shares bought by my parents or that I have made a ton of money on Reliance or Apple, so I should continue to hold them.

The cash test

Think that if my portfolio was liquidated and in cash today, how would I allocate it? What would I buy? Would it be the same assets? In the same proportion? The last is very relevant for your multi-baggers that may now be a disproportionate part of your portfolio.

So also for a large number of “riff-raff” securities that were hot once, you bought them and have seen them dwindle. If you had the cash today would you invest in them? In a very small number of cases the answer may be “Yes”.

In others, you are better off booking your losses, forgetting your history with the stock and investing in better quality assets and investments.

The Endowment Effect is very insidious and a very core part of our being, so the only way to overcome it is with a rigid set process of looking at your portfolio from scratch every quarter or at least annually—preferably with another independent set of eyes. That can be the beginning for optimising your portfolio.

I will be back soon with details of another investing bias.

(This is the second article in Devina Mehra's Investing Biases series for Moneycontrol)

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