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Why loss aversion matters

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Abstract: *Loss aversion is a phenomenon where gains and losses are unbalanced, which occurs in human financial activities. According to many studies, loss aversion will lead to erroneous results, such as human behaviors, government policies. Therefore, this paper needs to analyze these social problems brought by this behavior's improvement according to the causal relationship.*

Keywords: *loss aversion, behavior's improvement, financial activities*

1. Introduction

We might have been hearing lots of advertisements when we are out shopping, " These jeans are only available today."; "only this neckless left in the stock."; "don't miss out, buy it now." What role do these advertisements play in the selling market, and how does it help producers promote their products? In the following paragraphs, I am going to explain the principles behind some explicit phenomena - loss aversion.

2. Methology

2.1 Discoveries: Application 1

First and foremost, how was loss aversion discovered by humans? Daniel Kahneman (1991) provided an example [1] for his students; he said: "I am going to toss a coin, and if it's tail, you lose $10. How much would you have to gain on winning for this gamble to be acceptable to you?" Due to his vast experiment data, most people expect at least $20 for the winning outcome, roughly twice the wager. Even if we change the wager from $10 to $10,000, $20,000 is their response, which suggests a crucial conclusion to loss aversion: loss aversion is very much a consistent phenomenon regardless of the amounts involved. To explain the reason for this behavior deeply, we have to introduce its definition. "Loss aversion is the tendency to prefer avoiding losses to acquiring equivalent gains." said Daniel Kahneman. So, people demand a doubled reserve because they do not want to lose their money, and a loss of $10 is perceived as an equivalent gain of $20 in this case.

As a result of this, individuals tend to avoid losses in any possible ways. Loss aversion plays a massive role in pricing and promotion and even affects product development. The importance of this type of cognitive distortion is equally high in areas like marketing and sales psychology. Therefore, back into the initial scenario, in the clothing market, some clothing brand stores will be special discounts to "lend" clothes for buyers to try on or even promise unconditional returns within seven days. Once the buyer takes the garment home and tried it on for a few days, they will have a strange psychological feeling that the garment itself belongs to them. So, when you return the clothes to the store, you will be very reluctant and eventually do not return them. In conclusion, when a person owns an object, he values the object's value significantly higher than when he did not own it, which is also the definition of the endowment effect. This point tells us that loss aversion also relates to the endowment effect very much that the endowment effect is more likely to be a particular example under loss aversion.

2.2 Why it happens: Application 2

How and why does loss aversion happen? It can be explained by four aspects: the human brain; cultural difference; wealth effect; and people's own experience. First, some parts of our brain control our feelings and emotions that contribute to our response when we met losses. The amygdala (Canessa et al., 2013) [2] were to control the emotion of fear when met dangerous, which illustrate the direct relationship between losses and fear. The striatum [3] is used to help us make accurate predictions but are more active when we met losses, which helps us avoid losses. Finally, the brain's insula [4] plays a vital role in

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avoiding loss behaviors with the amygdala and is more active when losses occur. Moreover, your cultural background helps determine how loss-averse you are. Simply speaking, we could roughly divide cultures into two types: individualist culture and collective culture. For instance, a collectivist cultural background may provide closer social connections, which means you are more likely to be helped by others in the society like friends, families, or institutions when you do something wrong. This will make individuals preferring to take some risks and not feel the losses quite as much.

In contrast, with an individualist cultural background, you won't have the same ingrained cultural norms as a collectivist cultural form, which will lead to a weak safety net and more immense possibilities to have a severe aversion loss. Equally important, the effects of wealth and power are also crucial. Wealthy and powerful people usually have higher acceptability towards losses and a means to compensate them. Going back to the coin-tossing experiment in the beginning, if there are two people, one with $1,000 deposits and another with $1,000,000 deposits, a $10 may be a loss for some poor people that they may demand a $20 as equivalent value; however, an influential person can be less sensitive to a loss of $10 as acutely, since they have enough money to supply for their losses.

Above all were the experiment results from Ena Inesi of the London Business School. More interestingly, a study in Vietnam (2018) shows a different view about the relationship that "It's not how much money you have that matters. It's how wealthy your social environment is compared to the norm." This means that wealthy people in a poor village will tend to be more averse to losses than poor people who live in a wealthy village. Finally, education also plays a vital role in the degree of loss aversion. Higher education level confers more extra benefit that results in a more accurate understanding of the world which is more likely to lead to less loss aversion. [5]

2.3 Why We Care About It: Application 3 & 4

Why do we care about loss aversion? It may be because the loss aversion prevents people from taking risks and may lead to illogical behavior that will eventually lose potential profits and advantages. Endowment effect should be one of the reason. More specifically, when we are trapped in endowment effect, we think the value of things we owned greatly exceed the value of things we didn’t. This may likely to cause a bias called status quo, which means people are more likely to stay in their current position with ought any changing. This, in some extend can make people irrational such as do not want to change investment portfolio, may want to stay in an unhappy marriage, afraid of trying everything that is new to them. And this is also why we want to care about loss aversion, since in many cases, changes and challenges are good for human-beings. Connecting this to business, changes and challenges can motivate people to make more effort and developing their potentials approach multiple discipline.

Moreover, loss aversion also helps government to control people's behavior by using this principle. Posting tax may be used to avoid loss by the government to decrease the consumption of inferior goods. In 2015, October UK passed a policy to combat the large amount of use in disposable plastic shopping bags, in its case a five-pence charge for each one; while some other countries also try to increase the use of reusable bags, which be the substitutes of disposable ones by providing a 5-cent incentive. Before the experiment, many economists suggest the exact effects of these actions since they have the same monetary amount.

Nevertheless, a 5-cent tax result led to a 40% decline in disposable bags but nearly no change in the 5 cent incentive scenarios. This is because people are loss averse that they want to try their best to avoid any losses but care less about equivalent gains. [7]

3. Limitation of Loss Aversion and The Existence of Loss Attention

Finally, a question appeared: is loss aversion rational or suitable for a consumer in their life? Many people will answer positively since this psychology helps them avoid any losses, but I argue against this opinion for some reasons. First, it prevents us from taking risks and loses a much greater value than taking risks. Like when one's stock loses its value when a stock is losing money, many people do not sell it because they feel it will be lower overall than what they paid for it, resulting in a more considerable loss. Instead, they hold on and hope that the value will recover. This, more likely, will lead to even more significant losses, which is irrational and happened elsewhere when people are going to sell their house below the value, they purchased it. Even though selling at that moment may be the best option and the immense amount an individual will receive for their purchase, people may be unwilling to make that financial decision as they perceive it as an overall loss.

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Thus, a shared philosophy among stock traders is that you should not check up on it anymore to help people avoid putting more attention on the losses but the potential gains once you have sold the stock. Here, I also want to introduce a new definition of loss attention. According to Eldad Yechiam and Guy Hochman (2013), loss attention refers to individuals' tendency to allocate more attention to a task or situation when it involves losses than when it does not involve losses. [8] What distinguishes loss attention from loss aversion is that it does not imply that losses are given more emotional weight (or utility) than gains. Moreover, under loss aversion, losses have a biasing effect, whereas, under loss attention, they can have a debiasing effect. An example is the performance advantage attributed to golf rounds where a player is under par (or in a disadvantage) compared to other rounds where a player is advantageous.

The difference could be attributed to increased attention in the former type of rounds. Furthermore, they will eventually be more likely to win in the following rounds. Benartzi and Thaler (1995), who suggest the phenomenon [9] that Investors are loss averse and evaluate their portfolio too frequently, in the short term, losses are experienced more frequently than when examining performance over a longer time horizon, also believe that if loss-averse investors do not evaluate their investment performance frequently, they will be more willing to take risks, that is, the longer the evaluation period, the more attractive the risky asset is, and the lower the risk premium sum. This can also be a way to avoid loss aversion.

4. Conclusion

Overall, when we are getting more and more explicit about the drawbacks of loss aversion, what can we do to avoid being too averse to losses? First, by framing, we can frame the problem that can be affected by loss aversion that only considered the potential benefit and highlights the gains. [10] or we can also improve our perceptions, views, and knowledges that can better understand the world, standing in a higher position to avoid making irrational behaviors, thus avoiding loss aversion. Finally, another exemplary method may be to remind ourselves and consider our decision to maximize the long-run gains.

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