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Middle School Version

Focus on **FINANCE**

The Endowment Effect

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GLOSSARY

Endowment effect: People's tendency to value things they own more highly than they would if they did not own them.

Loss aversion: People's tendency to place more emphasis on what they have to lose rather than on what they have to gain.

Opportunity cost: The value of the next-best alternative when a decision is made; it's what is given up.

Sunk cost: A cost that has already been incurred and cannot be recovered.

"We don't want to give up what we own partly because we overvalue it, and we overvalue it partly because we don't want to give it up."
—Dan Ariely

The Emotions of Ownership

Think of your most prized possession. Now, imagine you decide you must sell this item. How much is it worth to you? How much would you charge for it? And would anyone else want to buy it at *that price*?

Let's consider the real-world example of a yard sale. Before your neighbors come to look at your things, you must first decide on the prices for them. For *you*, each item has a story, and some items may even evoke strong emotions. Let's say you're selling a pair of special edition sneakers that you took care of and really enjoyed wearing on special occasions. With these fond memories in mind, you put a price tag of $130 on the sneakers.

When a customer asks about them, you take time to share the story of how those sneakers were the best you've ever owned. The customer offers $50 for them. You think, "How could they not see how special and valuable these are?"

In financial transactions such as these, sellers often believe their own items are worth more than buyers are willing to pay. This occurs because buyers do not have the seller's experiences with and emotional attachment to the items. Buyers want a good deal, and even knowing the history behind an item does not mean they're willing to pay what the seller is asking for. This negotiation process can even feel a little painful for the seller—over losing something and the buyer not valuing it as much. Economists suggest this dynamic occurs through the **endowment effect**—people's tendency to value things they own more highly than they would if they did not own them. The endowment effect can take hold anytime we feel a sense of ownership over a product, and it can happen quickly. It can be a product that we simply pick up and contemplate purchasing, a product we bid on at a virtual auction, or even an item we are handed at no monetary cost.

The Endowment Effect for an Owner

Behavioral economist Dr. Dan Ariely highlights “three irrational quirks in our human nature” that come through when shopping for and purchasing items.[1] The first quirk is love. People fall in love with their possessions. These emotions go beyond the original purpose of buying a good. Some emotional connections and experiences are tied to it. You can develop an emotional connection to an item through the process of putting it together. The “IKEA Effect” (boxed insert) details the sense of pride and admiration people have for what they’ve accomplished after investing time and energy into putting an item together.

The second quirk is a sense of loss. Over time, the love people develop for things they own makes it harder to lose them—overpowering the thought of what they have to gain. For example, having a yard sale is an excellent way to de-clutter spaces and make some money at the same time. The feeling of gaining space and earning money should feel more exciting than selling smelly sneakers. The fact that someone wants to pay you less than what you think the shoes and memories are worth can be hard to accept. It might make you feel that you have more to lose than you have to gain by selling the shoes. Behavioral economists refer to this as **loss aversion**—people’s tendency to place more emphasis on what they have to lose rather than on what they have to gain.[2] The emotion that goes with giving up an item weighs heavier on the heart than the feeling you had when you first acquired the item.

This brings us to the third quirk, which is assuming that a buyer will have the same emotional attachment to an item as the seller. Emotional attachment can develop through a person’s experiences with an item, including the thought they put into purchasing it and, in some cases, the investment they made in customizing and maintaining it. Take, for example, a car. We spend a significant amount of time in them and often add our personal style to these spaces. This includes purchasing seat covers in a favorite style and color, but also doing the required repairs, researching the best tires, and putting our hard-earned money into making sure it runs well. A car seller may point out all of this, and the buyer may appreciate it, but that does not mean they will pay the asking price.

The “IKEA Effect”: If You Build It, You Will LOVE It

Professor Mike Norton, professor Daniel Mochon, and behavioral economist Dan Ariely have written about what they’ve named the “IKEA Effect.” Visiting IKEA is an adventurous shopping experience. It’s a large store with a showroom, restaurant, and childcare area, and it offers customers oversized shopping bags for holding smaller items (all named with Swedish words). Its second-floor showroom has all the assembled furniture, accents, and accessories. Customers shopping for furniture see what they like, write down its location in the showroom, and pick up the boxes with the parts to assemble the item on the first floor. It took some work to get it, but now it’s time to go home and begin assembling this special piece of furniture.

After getting home, shoppers unload and open their boxes. Let’s say you bought a chest of drawers and think putting it together cannot be that hard. Time to create a masterpiece! About six hours go by, after a few choice words and the thought of taking a hammer to it, but, finally, you have a chest of drawers for all to admire. You built it and now you feel even more connected to it because you invested your time into making it. The feeling is beyond attachment; it is now a feeling of accomplishment and admiration for the thing you put together. This is what Norton, Mochon, and Ariely say is the “IKEA Effect”: You build it, so you love it!

SOURCE: Norton, M.; Mochon, D. and Ariely, D. “The ‘IKEA Effect’: When Labor Leads to Love.” Working Paper 11-091, 2011; https://www.hbs.edu/ris/Publication%20Files/11-091.pdf.

The Endowment Effect for a Buyer

Stores are filled with items that we imagine owning to add joy or value to our lives. Before anyone formerly researched and named the endowment effect, retailers realized the power of touch.[3] Trying clothes on, pressing buttons, or getting to hold an item can impact purchasing decisions more than one may think. Doing these things can instill a sense of ownership before a shopper even pays for an item. Some businesses will even allow customers to try a product at a cost lower than the retail price, often for a trial period (say, 30-90 days) and with little to no risk.[4] “No risk” often means a shopper can return an item for a full refund during the trial period. Giving customers a trial period helps them feel ownership, and it can sometimes translate to monthly or annual subscription purchases. (Think of the free trial period of your favorite television streaming service.)

Dan Ariely points out another ownership experience that he calls “virtual ownership” or partial ownership.[5]

Using the website eBay as an example, Ariely points out that shoppers can feel ownership of a product without even touching or owning it right away. Ariely's research has shown that this feeling causes people to bid higher and higher in online auctions. The emotional process of bidding on an item generates thoughts in the bidder: They imagine themselves owning and using the item. This idea of virtual ownership makes losing a bid hurt even more.

But I Paid So Much for It!

Now let's imagine having purchased a used car for $8,000. This car ran great for the first four months, but it had some significant problems and needed some expensive repairs after that. The car still has some issues that need to be worked out, but the mechanic said the repairs may cost more than the car is worth, so it may be time to replace the vehicle. The question is whether to keep the car or sell it. It is a difficult decision because, in addition to paying the $8,000 for the car, you also paid for several expensive repairs and cannot recover that money. This is a dilemma people face with other decisions, too, and it's known as **sunk costs**—costs that have already been incurred and cannot be recovered. Both the emotional and monetary investments people have in their items can make it harder for them to give something up. (This is loss aversion at work!) Emotions tend to cloud one's mind from making the best decision, as people may consider spending money on something where the costs outweigh the benefits.

Overcoming the psychological obsession with sunk costs is possible. You can place less emphasis on past investments and more emphasis on moving forward, including focusing on the value of what you have to gain. Dan Ariely states that "throwing good money after bad adds wishful thinking." In other words, because you can't recover sunk costs, they should not enter into your current decisionmaking.

Conclusion

As the saying goes, "Emotions get the best of us." There is nothing wrong with being proud of owning things and treasuring your experiences with them. But when you consider selling a prized possession, think about whether you're fully ready to part ways with it. The past is the past, though, and focusing on what you cannot recover could possibly cause you to miss out on future possibilities. Removing your emotional attachment to material possessions can help you make more accurate assessments of how much your items are truly worth. If you decide to sell an item, realize that buyers will not consider the emotional investment you have made in the good. Rather, seek a price that satisfies both you as the seller and a potential buyer. Negotiation does require compromise.

The endowment effect is a concept that is important to both sellers and consumers. As a consumer, it is essential to keep in mind the value an item will add to your life before purchasing it. Spending involves making decisions and considering the **opportunity cost**—the value of the next-best alternative when a decision is made; it's what is given up. It's easy to feel a false sense of ownership or fear missing out by being outbid. But you have many choices, so be sure to consider what else you could do or experience with the money you are considering spending.

Notes

[1] Ariely, D. and Kreisler, J. "We Overvalue What We Have," in *Dollars and Sense*. New York, NY: HarperCollins, 2017.

[2] Behavioraleconomics.com, Behavioral Science Solutions Ltd, "Behavioral Science Concepts," Loss aversion; https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/loss-aversion/, accessed January 10, 2022.

[3] Bell-Metereau, M. "The Endowment Effect—What It Is and How It Can Sabotage Your Budget." *Money Crashers*, September 2021; https://www.moneycrashers.com/endowment-effect/, accessed December 15, 2021.

[4] Bell-Metereau, 2021. See footnote 3.

[5] Ariely, D. "The High Price of Ownership," in *Predictably Irrational*. New York, NY: HarperCollins, 2009.

Name______________________________________ **Period**________

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"The Endowment Effect"

After reading the article, answer the following questions.

1. Which of the following best describes someone experiencing the endowment effect?
   a. Rachel is willing to give away all of her old toys for new ones.
   b. David will only sell his favorite car for the asking price of $5,000.
   c. Scott has zero attachment to the house he owns and sells it for less than it's worth.
   d. Stacy is excited to sell her collection of purses because she needs the cash.

2. The fact that people place more emphasis on losing rather than gaining something is known as what?
   a. Loss aversion
   b. Opportunity cost
   c. Sunk cost
   d. Partial ownership

3. "Virtual ownership" refers to a customer's feeling of ownership of a product without even touching or owning it right away.
   a. True
   b. False

4. Buyers of used goods will usually consider the personal experiences a seller has had with an item and offer more than the asking price.
   a. True
   b. False

5. The "IKEA Effect" refers to a sense of pride, value, and ownership that people place on things they take time to put together.
   a. True
   b. False

6. One way to avoid the endowment effect is to own as much as possible without regard to how much money you spend.
   a. True
   b. False

7. Taking into account the next-best alternative when making a decision is known as what?
   a. Loss aversion
   b. Opportunity cost
   c. Endowment effect
   d. Partial ownership

8. Which of the following is the best example of the endowment effect?
   a. Going to a yard sale to look at items and not purchasing anything
   b. Feeling that you have a lot more to gain than lose when selling an item
   c. Being given a mug for free and then only willing to part with it for $20
   d. Not having an emotional attachment to any item you own

9. One of the reasons that makes it so hard for people to deal with sunk costs is that
   a. people have emotional and monetary investments in their items, making it harder to give them up.
   b. people find it easy to not care about the amount of money they spent/invested.
   c. the feeling of losing money is equal to that of gaining money.
   d. people place little emotional importance on the money they spend.