



Heuristics & Biases

Part 2

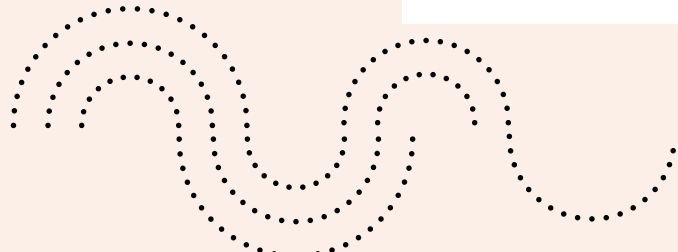
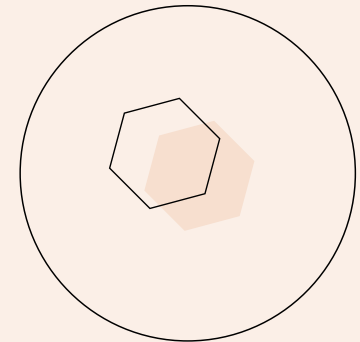
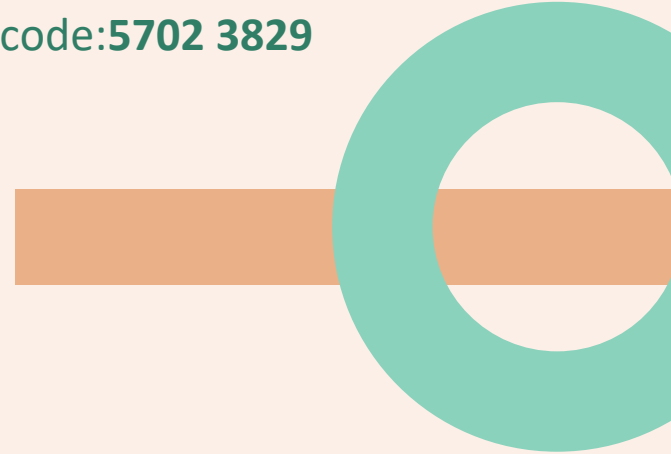
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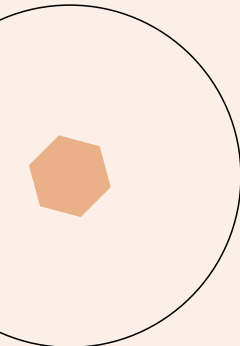
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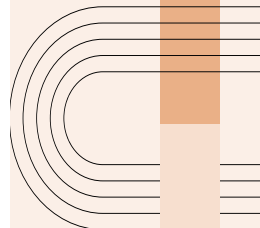

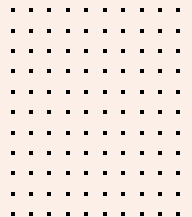
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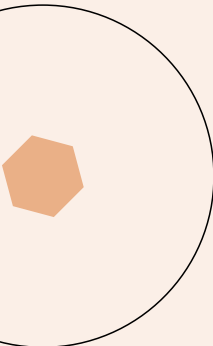
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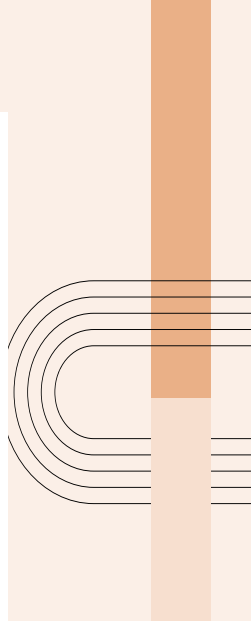
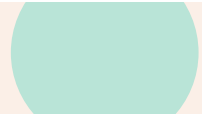


2. You are a serious reader of the financial pages but until recently have had few funds to invest. That is when you inherited a large sum of money from your great uncle. You are considering different portfolios. Your choices are:

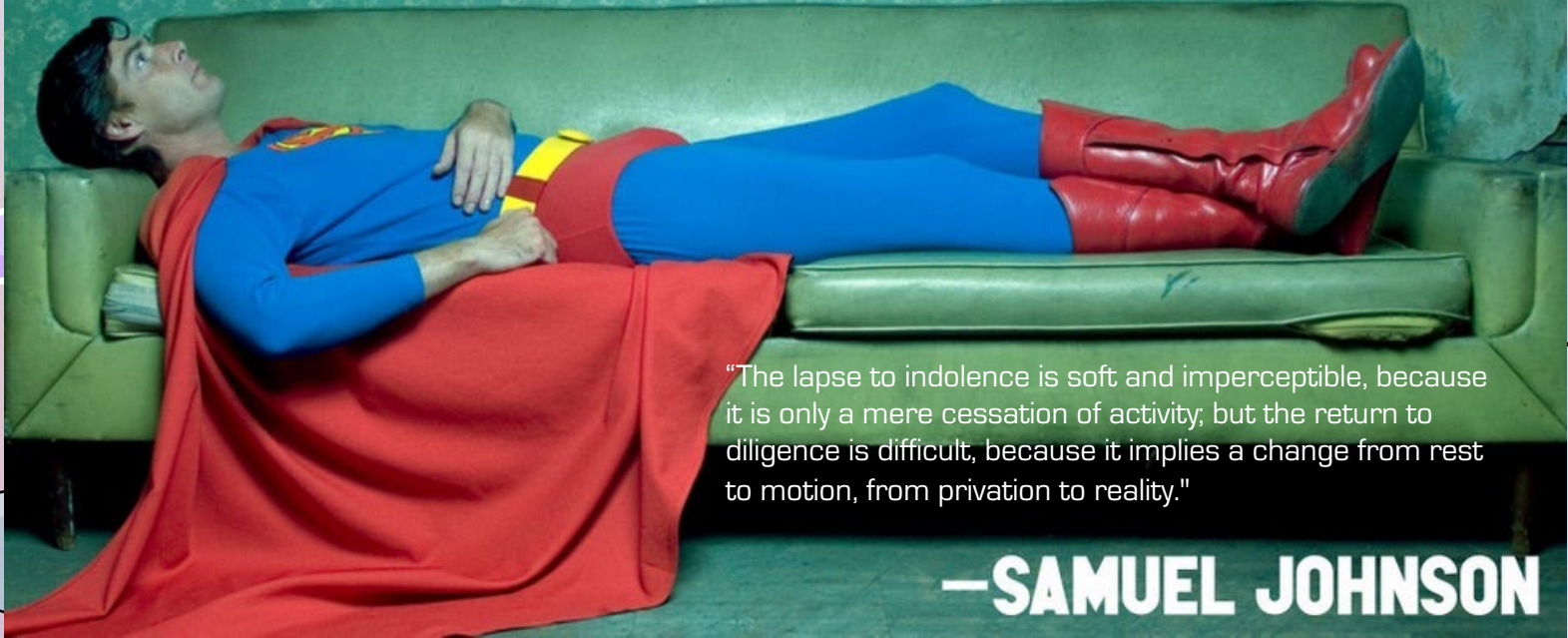
- _____ a) Invest in moderate-risk Co. A. Over a year's time, the stock has .5 chance of increasing 30% in value, a .2 chance of being unchanged, and a .3 chance of declining 20% in value.
 - _____ b) Invest in high-risk Co. B. Over a year's time, the stock has a .4 chance of doubling in value, a .3 chance of being unchanged, and a .3 chance of declining 40% in value.
 - _____ c) Invest in treasury bills. Over a year's time, these will yield a nearly certain return of 9%.
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2'. You are a serious reader of the financial pages but until recently have had few funds to invest. That is when you inherited a portfolio of cash and securities from your great uncle. A significant portion of this portfolio is invested in moderate-risk Company A. You are deliberating whether to leave the portfolio intact or to change it by investing in other securities. (The tax and broker commission consequences of any change are insignificant.) Your choices are (check one):

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TO DO NOTHING IS IN EVERY MAN'S POWER.



"The lapse to indolence is soft and imperceptible, because it is only a mere cessation of activity; but the return to diligence is difficult, because it implies a change from rest to motion, from privation to reality."

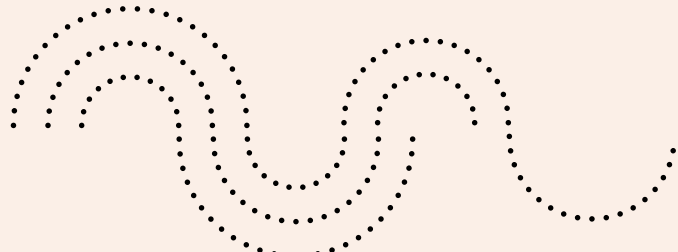
—SAMUEL JOHNSON



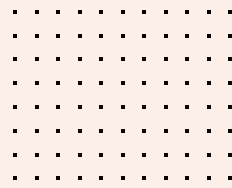
Status Quo Bias



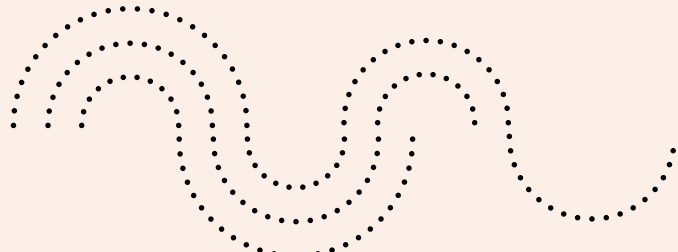
Most real decisions **have a status quo alternative**- that is, doing nothing or maintaining one's current or previous decision.



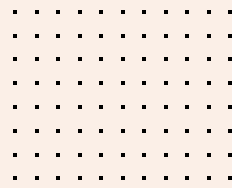
Status Quo Bias



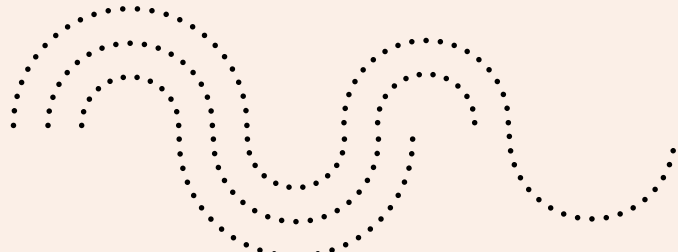
- **Status quo bias** refers to the finding that an option is more desirable if it is designated as the “status quo” than when it is not (Kahneman, Knetch, Thaler, 1991).
- People prefer things to stay the same.
- They are comfort-seeking by trying to stay with the current state.

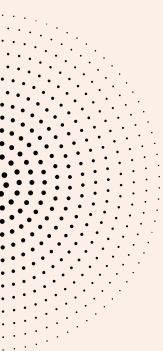


Status Quo Bias



- They are resistant to change.
- As **a heuristics**, status quo bias is using the rule of thumb that “stick with what you have unless there are strong reasons for doing otherwise.”





Status Quo Bias:

Behaviors that can cause investment mistakes

- Status quo bias can cause investors, by taking no action, to hold investments inappropriate to their own risk/return profiles.
- This can mean that investors take excessive risks or invest too conservatively and **don't achieve proper portfolio allocation.**



Status Quo Bias:

Behaviors that can cause investment mistakes

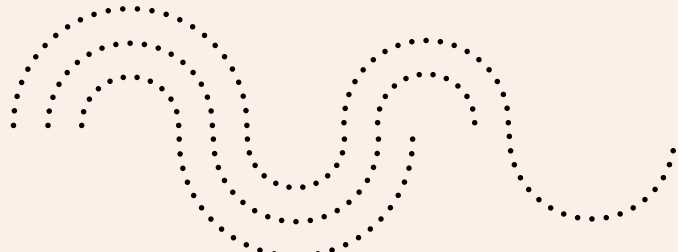
- An investor facing an opportunity to reallocate or alter an investment position may choose, instead, to maintain the status quo because the status quo offers the investor an opportunity **not to realizing a loss**.
- This will be true even if, in the long run, the investor could achieve a higher return by electing an alternative path.

Samuelson & Zeckhauser (1988)'s experiment

Goal: To test for status quo effects

Condition:

- In **the neutral version (NEUT)**, the subject faces a new decision and must choose from several alternatives, **all on an equal footing**.
 - All four choices will be presented as new alternatives.

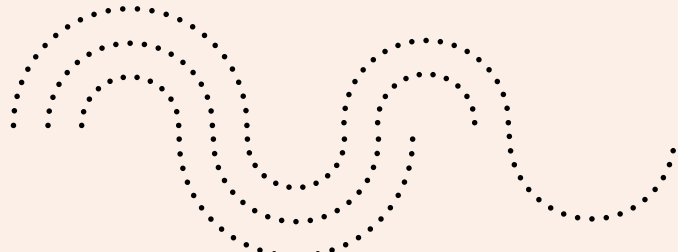


Samuelson & Zeckhauser (1988)'s experiment

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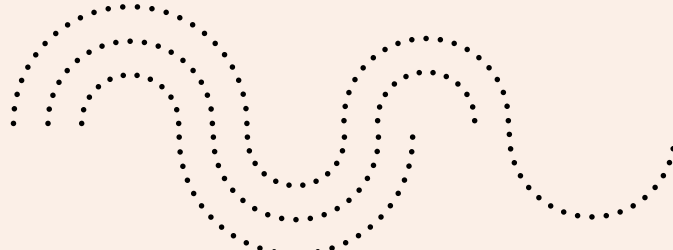
- In **the status quo version (SQ)**, one alternative occupies the position of the status quo.
 - The first alternative is portrayed as the status quo

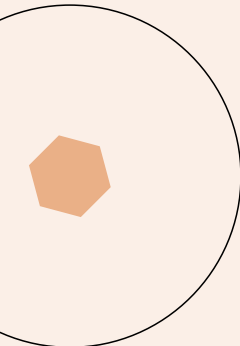




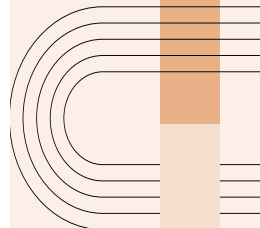

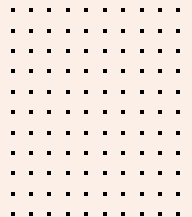
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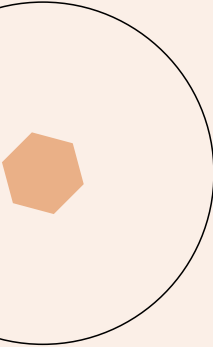
Subjects:

- The subjects in the experiments were students in economics classes at Boston University School of Management and at the Kennedy School of Government at Harvard University.
 - In all, 486 students participated. More than three-quarters were first-year MBA students; the others were senior undergraduate business majors at BU and students in the public policy and public administration programs at Harvard.
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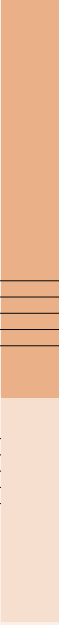



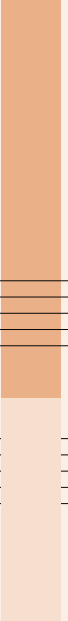
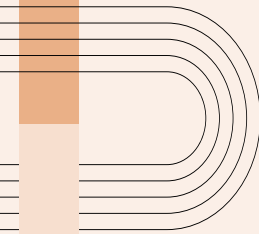


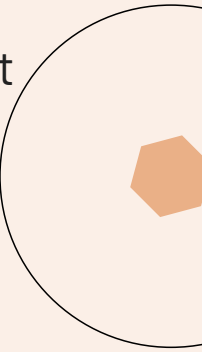
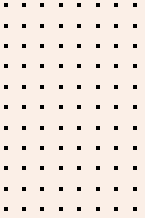
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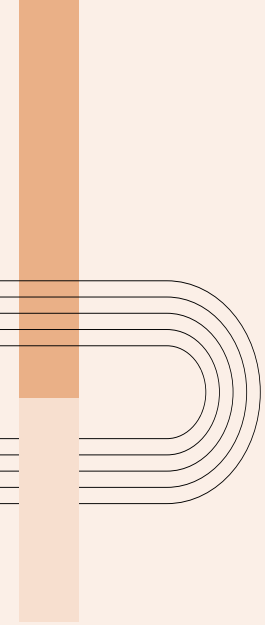


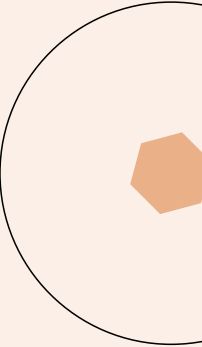
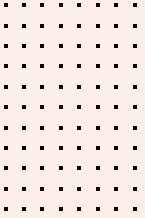
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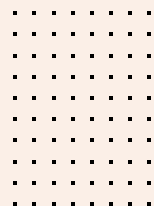
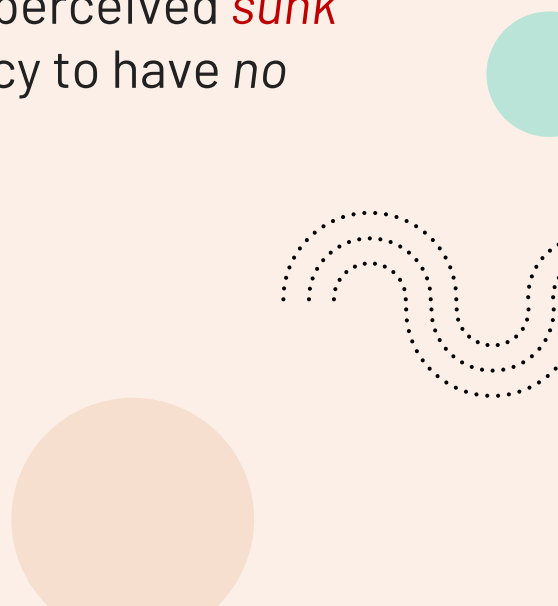
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- In decision 2', the status quo version (SQ) is to retain the investment in moderate-risk Company A.
 - In addition to this decision 2 and 2', three additional treatments were conducted, where participants were told that one of the other three investment choices had been left to them.

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- No matter which investment option was chosen as the original endowment, it was always the most popular choice.
 - People felt most comfortable with the current state of affairs even though it was not something that they had any part in choosing.



Explaining the status quo bias


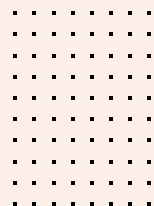
The observed status quo bias may be seen as the consequence of:

- (1) **Loss aversion**;
 - (2) Psychological commitment stemming from misperceived *sunk costs, regret avoidance*, or a drive for consistency to have *no cognitive dissonance*.
 - (3) Status-quo heuristics
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Rational explanation for staying at the status quo

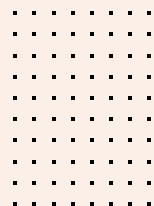

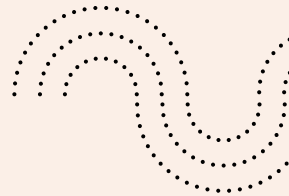

Decision making in the presence of **transition costs** and/or **uncertainty**

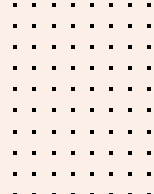
- Transition costs, for example, may make any switch from the status quo costly in itself.
 - The cost of switching exceeds the efficiency gain associated with a superior alternative.
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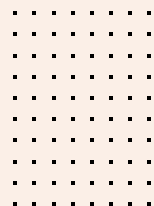

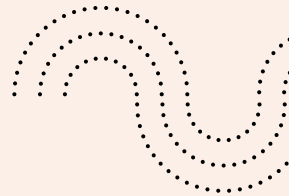

Rational explanation for staying at the status quo

Decision making in the presence of **transition costs** and/or **uncertainty**

- An individual may well stick to a low-paying job if the process of searching for a better one is slow, uncertain, and/or costly.
 - Even when no explicit costs are associated with search or switching, uncertainty can lead to status quo inertia.
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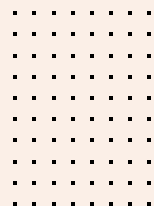



Can rational explanations for staying at the status quo explain the result of the experiment?

- For the result of experiment, since neither transition costs nor uncertainty plays an essential role in the hypothetical questions, the rational explanations are inadequate to explain status quo inertia.
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Explaining the status quo bias: Loss aversion

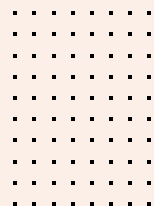
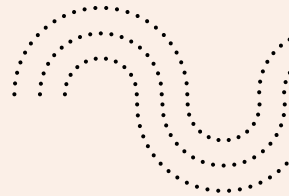
The observed status quo bias may be seen as the consequence of:

- Consider the choice between retaining the status quo or opting for a new alternative.
 - Taking **the status quo as the reference point**, the individual weighs potential losses from switching as larger than potential gains.
 - Because of loss aversion, the individual is biased in favor of the status quo.
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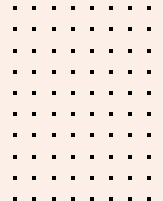
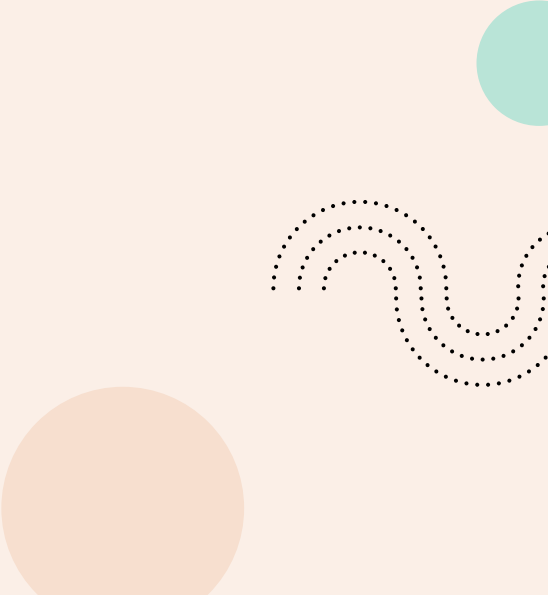
Can loss aversion explain the result of the experiment?

- In this experiment, the result shows the presence of status quo bias even when there are no explicit gain/loss framing effects.





Explaining the status quo bias: Sunk cost


- The presence of sunk costs or other resource investments contributes to status quo bias in decision making.
 - The greater the investment in the status quo alternative, the more strongly it will be retained.
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Explaining the status quo bias: Regret avoidance

- Kahneman and Tversky (1982) argue, individuals feel stronger regret for bad outcomes that are the consequence of new actions taken than for similar bad consequences resulting from inaction.
- Individuals fear the regret that might follow if active steps are undertaken to alter the status quo.
- It favors adherence to status quo norms or routine behavior at the expense of innovation, and it reinforces to the individual's inclination to conform to social norms.



Explaining the status quo bias: Cognitive dissonance

- The individual's drive to avoid cognitive dissonance in his or her role as decision maker contributes to status quo bias.
 - Past choices are "rationalized", and the "rationalization" process extends to current and future choices.
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MERCI !

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