

ENDOWMENT BIAS

As an Owner-Manager, are you willing to buy your business today at the same value that you would agree to sell it for today?

People exhibit endowment bias when they value an asset more when they own it than when they don't. Traditional economic theory holds that a rational person's ("homo economicus") willingness to pay for an asset should always equal that person's willingness to sell it for the same price. But behavioral economics studies (and our own scar tissue!) consistently show that the minimum selling price that owners state for an asset almost always exceeds the maximum purchase price that they are willing to pay for the same assets. Effectively then, (scratching our heads) ownership of an asset in and of itself "endows" the asset with some ethereal added value from the owner's point of view.

A classic case of endowment bias is where a business is "inherited." Often in these situations, Owner-Managers say that they have feelings of distress or disloyalty associated with considering new ownership alternatives for a business bequeathed from a previous generation. They are confused by what is "the right thing to do," and at what value. Endowment bias influences Owner-Managers to hold onto businesses that they have inherited, often regardless of whether it is in the best interest of the Owner-Manager, or of the business itself! Frequently, endowment bias results in decision paralysis where an Owner-Manager, having placed an irrational premium on a business that he owns, slowly liquidates the business, year by year, through his inaction.

Are you the victim of endowment bias? Ask yourself this: "If I had the value of my business in risk-free cash securities today, what proportion of my cash would I invest in this business today? At what price?" Or, (in the case of an inherited business) you might ask yourself, "Do I think that when my family left me this business that they thought that I would automatically accept the responsibility of keeping ownership of it forever, whether or not it is in the long-term best interest of the business or my family?" Familiarity with an asset you own is like comfort food. It feels good; it's comfortable. But if you wouldn't buy the business you own now for its fair market value for cash, then why do you own it?

Empirical evidence proves that trading experience in markets matters greatly when trying to solve for this bias. Across all asset types, market-specific experience and the magnitude of the endowment effect are inversely correlated. In other words, when an Owner-Manager has significant accumulated M&A experience the endowment effect decreases and at some point becomes negligible. But most Owner-Managers do not have this experience. And this has major implications for business owners for whom a recapitalization or sale transaction is their "only once-in-a-lifetime transaction." They have no deep trading experience and thus can become unwitting victims of endowment bias.

This is the Age of the Entrepreneur. There are many qualitatively meaningful reasons to own a business independent of its value. If you recognize the danger inherent in endowment bias (that almost all of us has) then you can better choose how to act to assure the longevity of the business beyond yourself as the current Owner-Manager of it.