Balancing Gains and Losses

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People generally fear losses more than they covet gains; losses are weighted more heavily than an equivalent amount of gains, e.g., the absolute joy felt in finding $50 is a lot less than the absolute pain caused by losing $50, a phenomenon known as "loss-aversion". Kahneman and Tversky stumbled upon loss aversion after giving their students a simple survey, which asked whether or not they would accept a variety of different bets. The psychologists noticed that, when people were offered a gamble on the toss of a coin in which they might lose $20, they demanded an average payoff of at least $40 if they won. The pain of a loss was approximately twice as potent as the pleasure generated by a gain. As Kahneman and Tversky aptly put it, "In human decision making, losses loom larger than gains."

If you ever kept a gym membership long after it has become clear that you are not now and will never be a gym rat, then you have felt the effects (i.e. "dead-loss" effect) of loss aversion. Think about how insurance is sold, not on what consumers will gain, but what they stand to lose—insurance (and warranties) is by definition designed to mitigate "loss".

Consider the following example of how loss aversion works. A grocery retailer has tried to decrease people's use of plastic grocery bags. One approach was to offer a five-cent bonus to customers who brought reusable bags. That approach had essentially no effect. Later the retailer tried another approach, which was to impose a five-cent tax on those who ask for a grocery bag. Though five cents is not a lot of money, many people do not want to pay it. The new approach has had a major effect in reducing use of grocery bags.

Here is another example of where loss aversion comes into play. Suppose two companies sell calling plans. Company A advertises their plan for $25.00 per month, with a $12 rebate for continuing the contract for at least one year. Company B advertises their plan for $24 per month, with a $12 surcharge for dropping out of the program before a year is up. Which is the better deal after one year's worth of calls? Of course, the economic costs of these two plans are identical, except that the plan offered by Company B is framed differently, i.e. as a potential loss, and would more strongly appeal to loss-averse customers.

Loss aversion has many practical applications in marketing, in particular when it comes to pricing, i.e. when using price increases, reference prices, limited time offers and price bundling.

Price increases – Whenever a customer sees a price increase, they interpret this as a personal loss. Hence, businesses often see extremely emotional reactions resulting in lost business (e.g. Netfix lost 800,000 subscribers in the 3rd quarter of 2011 after an announced price hike). One strategy, if possible, is to change the packaging of the product, e.g., Kellogg's reduced the size of its Frosted Flakes and Rice Krispies cereal boxes from 19 to 18 ounces. Frito-Lay reduced Doritos bags from 12 to 10 ounces. Dial Soap bars shrank from 4.5 to 4 ounces, and Procter and Gamble reduced the size of Bounty paper towel rolls from 60 to 52 sheets.

Reference prices – A reference price is what your customers expect to pay. If they are forced to pay more than this they consider it a loss. Less is a gain. Existing customers often use the last price paid as their reference price (and smart phones now offer instant reference pricing data). However, for new customers, firms have the ability to influence their reference price. We often see retailers show MSRP and then a marked down price--this to influence the reference price. Alternatively, some companies choose to compare their product to one that is much more expensive in hope of increasing the prospect’s reference price (a tactic frequently used by off-price retailers like Ross or T.J. Maxx).

Limited time offers – If Macy’s is willing to sell a jacket at 50% during a sale that ends Sunday, why wouldn’t they sell it at 50% off on Monday? The answer is loss aversion. If potential buyers are on the fence about buying the jacket, they are more likely to go purchase it while it’s on sale. Once Monday comes they have lost the opportunity. If Macy’s doesn’t stop the sale on Monday they don’t have the extra incentive to go buy on Sunday (Walgreens features “Senior Tuesday” sales). Loss aversion is one factor that drives the success of “sales”.

Bundling – charging a single net price for the overall exchange hides gains and losses on the component transactions and allows consumers flexibility in mentally apportioning the net price across the components in a manner they construe favorably.

People and customers in particularly don’t like to lose. This is why good marketing and sales is often all about convincing prospects that what they are about to buy is worth more than what they must pay for it. Something is seen as a good value when any perceived pain of loss will be more than offset by the joy of gain.

So, what about you, are you more likely to avoid losses or pursue gains?

William (Bill) Johnson, Ph.D., is a Participating Faculty in Marketing and at the H. Wayne Huizenga School of Business and Entrepreneurship, Nova Southeastern University. He can be reached at **billyboy@nova.edu**