

How to Leverage Loss Aversion/ Prospect Theory for Pricing Negotiation

by: Raymond Augustin

In this article, the author explains the psychological phenomenon of “loss aversion” and how it can be applied in pricing strategy. Raymond Augustin is a recognized thought leader specializing in pricing strategy. He has, as the COO of Virtual Procurement Services (VPS), provided guidance to dozens of healthcare organizations and tribal gaming operations on purchase price methodology and analytics.

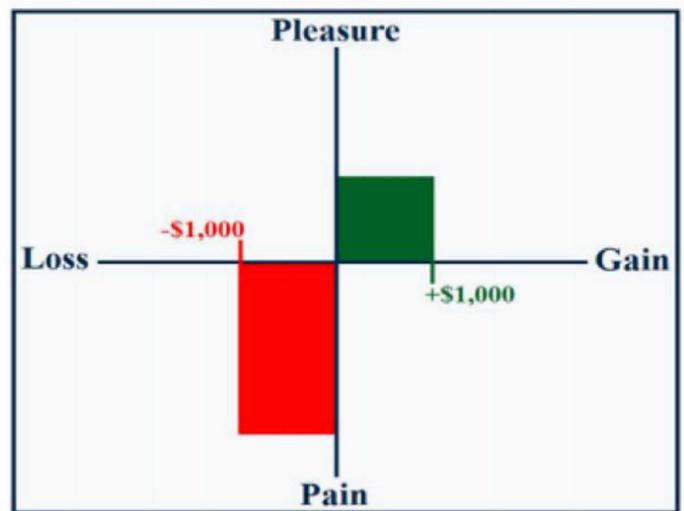


What is Loss Aversion?

The emotional pain of losing is twice as impactful as the emotional joy of winning. Loss aversion is an identified preference or bias in our thinking and evaluation process that is used to describe why the pain of losing something is psychologically about twice as powerful as the pleasure of gaining something. This phenomenon was observed by Tversky and Kahneman and published in their seminal work. For this reason, we think it is better not to lose \$20 than to find \$20. It is also why when our team is favored to win, but loses, it is more psychologically crushing than the joy of your supported underdog’s victory.

Source: Amos Tversky & Daniel Kahneman “*The Framing of Decisions and the Psychology of Choice*”

Loss Aversion: Losses are Twice as Painful as Gains are Pleasurable



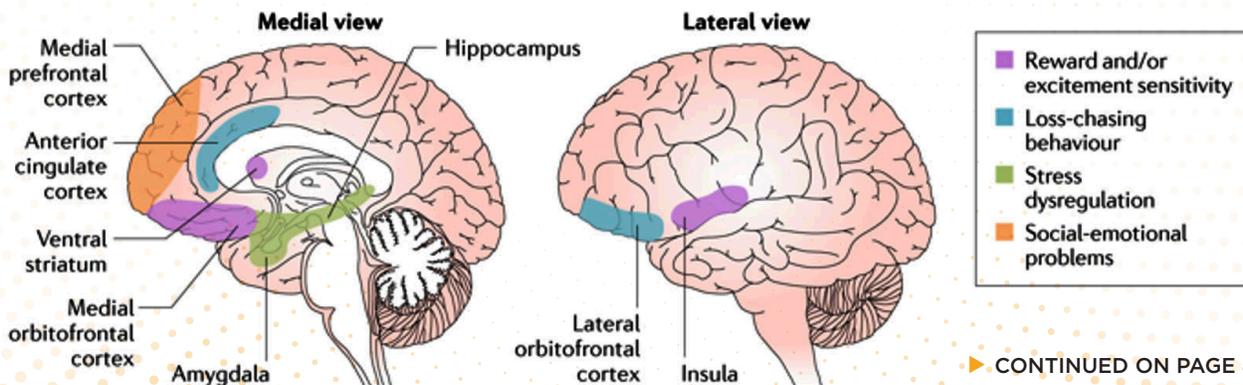
There are 3 specific regions in our brain that contribute to this loss aversion:

- Amygdala • Striatum • Insula area

When we are faced with a potential loss, the anxiety-inducing

and stress-activated Amygdala kicks in, which stimulates an emotional reaction for loss that is similar to its equivalent for fear. The Striatum then assesses the situation to see if this is - or is close to - a scenario that has been seen before to determine if

there are approaches to mitigate any possible loss. The Insula region then provides the impetus for moving forward with those alternatives and **there is a direct correlation between the increased sense of loss and the Insula area’s activation.**



▶ CONTINUED ON PAGE 8

How can sales teams use this when price is an issue?

The most prevalent use of this cause and effect is to create **scarcity of either product or of time**. When you use urgency to sell, you take “tomorrow” off the table altogether. The sale price is only available during “x” period, or this product will not be available after that “limited time.” Utilizing quotes or proposals with end dates for the pricing therein is a gentler (and more subliminal) method of applying this type of pressure. Coupled with an announcement or ‘rumor’ of a price increase, this then becomes a full-fledged application of loss aversion on the customer.

The other approach is the **‘try and buy’** or **‘POC’** (proof of concept). The vendor is able to get the product into the hands of the prospective customer to be used by a wider audience.

Studies by Peck and Shu have confirmed that merely touching an object results in an increase in perceived ownership of that object. After just a few weeks, the thought of returning this item becomes a pain point along the lines of prospect theory (i.e., losing something they had vs. not getting something they did not possess to start with). Car dealers have always been good at this with their “test drives,” and companies like Carvana now offer “7 days to see if your car truly fits into your life.”

Some other not so subtle ways that seem to work:

- Coupons
- Pre-orders
- 2 for 1 (or BOGO)
- Doorbuster specials

Sales professionals practice this in a more sophisticated way by having the customer budget at

the line-item level for the item(s) they are selling. Research shows that people do experience loss aversion about their outlay when they are spending money they have already allocated (on paper or mentally) for a specific purpose.

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