

# P E R S P E C T I V E S

An excerpt from "Perspectives" - Volume 11 - Issue 2

Behavioral finance

## Anchoring: When to hold on – and when to cut free

By Stan Clark - Senior Investment Advisor

**Behavioral scientists Amos Tversky and Daniel Kahneman once asked a group of people what percentage of African nations belonged to the United Nations. But the scientists' question had a twist.**

Before asking each person, Tversky and Kahneman spun a wheel of fortune. They asked them whether the percentage would be higher or lower than the random number the wheel had spun to. Then they asked them to estimate the exact percentage.

The wheel's spin hugely affected people's guesses. When it pointed to 10, the median answer was 25%. But when it pointed to 65, the median answer was nearly double that: 45%.

Would any rational person think the spin of a wheel could affect the number of African countries in the U.N.? I doubt it. Yet, it did just that in the incident I've described.

In this article, I'd like to talk about a psychological bias called *anchoring*. This is our tendency to rely too heavily on one piece of information when making a decision – without thinking about it, even if we know the information is irrelevant. I'll also discuss when to hold on to such information – and when to cut free of it.

In another experiment, Massachusetts Institute of Technology Professor Daniel Ariely held a mock auction. Ariely asked his students to write down the last two digits of their Social Security numbers. Then he asked them to bid for items such as chocolates, a cordless keyboard and wine. For the cordless keyboard, the students with the lowest numbers (one to 20) made an average bid of \$16. Those with the highest numbers (80 to 99) bid an average of \$56, more than three times as high.

The trend held across all products. Students who had written down higher numbers were willing to spend *an average of 300% more* than those with lower numbers.

When buying or selling, people tend to strongly anchor to the list price or the pre-sale price. If you're selling your house in a down market,

---

*Investors are often overly affected by a stock's previous high or low price, or by what they paid for it.*

---

you may be anchored to your initial asking price. When the market falls a little, you hold out for your price. As a result, you may pass on a reasonable offer. Later, when the market falls more, you finally adjust your price and sell – but possibly for much less than the earlier offer you refused.

Anchoring explains why many negotiators begin by asking for a very high price. They hope the counterbid will be close to what they really want. Anchoring also accounts for why people feel overly confident in new business ventures. Anchored to their first successes, they dismiss or underestimate problems down the road.

Investors are often overly affected by a stock's previous high or low price, or by what they paid for it. This can cause people to hold on too long to losers, or to buy stocks like Nortel at \$60 per share because it seems like a bargain compared to the share's peak of \$120.

We should be on the lookout for anchoring in all our financial decisions. Being aware of anchoring can help us save money – and prevent us from making big financial mistakes. ■



Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.



CIBC  
Wood Gundy

The Stan Clark Financial Team

Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca

Stan Clark is an Investment Advisor with CIBC Wood Gundy in Vancouver, BC. The views of Stan Clark do not necessarily reflect those of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors. Transactions in insurance products, including segregated funds, are made on your behalf by CIBC Wood Gundy Financial Services Inc., or in the case of Quebec residents, CIBC Wood Gundy Financial Services (Quebec) Inc. If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.