

PERSPECTIVES

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,

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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. ■



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