BEHAVIORAL FINANCE 101 - ANCHORING

How do our thoughts and feelings affect our financial decision-making? More ways than we might imagine. So far this year, we've talked about Loss Aversion and Endowment, Regret and Status Quo, Sticking with the Herd and the ongoing battle between Optimists and Pessimists. This month we turn our attention to "Anchoring."

I've heard the premise that a diamond engagement ring should cost around two months of salary. Now, this has nothing to do with a valuation of your love for your fiancée, but is just something dreamed up by the jewelry industry to maximize their sales. Nevertheless, if you are informed that this is the "standard," it sticks in your mind and you might feel like a cheapskate if you spend less.

Guess what? You have just been "anchored."

Suppose you visit a car dealership and see the sticker price on a new auto. What does "sticker price" really mean anyway? There are many incentives, "dealer holdbacks", or other behind-the-scenes items that will affect your real price, but the sticker price does serve the dealer's purpose of*anchoring* you to a starting point in the price negotiation process.

Here's a test I read about recently: First, a roulette wheel was spun and a ball would land on a random number between 1 and 100. Next, people were asked whether the percentage of United Nations membership accounted for by African countries was higher or lower than the number on the wheel. Finally, these same people were asked to give their own estimate of that percentage. It was found that the initial random anchoring value on the wheel affected their answer – so if the number on the wheel was higher, you tended to guess a higher percentage of African countries.

This same anchoring process occurs with our finances.

Suppose you buy a stock for $50 a share, but it drops to $30 a share. Now, the $50 price is important. For tax purposes, it is the number that will determine the gain or loss you must report on your tax return when the stock is eventually sold. And, when measuring your investment success or failure, it is the starting point in that calculation. However, from an investment decision-making viewpoint, the $50 price you paid is irrelevant. With the stock sitting at $30 a share, the only relevant thing to talk about is whether the future prospects for this company justify keeping the stock or whether your $30 should be moved into a different investment.

But, our brains often don't work like that. Instead, we think "I paid $50 and I don't want to sell it for $30 and incur a $20 loss – so I need to hang onto this stock, at least until it climbs back up to the $50 I paid for it." We are mentally anchored to the original $50 cost and we also want to avoid the pain of actually recognizing the $20 loss. Of course, whether we sell the stock or not, the $20 loss has occurred, but postponing the sale helps us to also postpone the emotional anguish.

We also anchor ourselves to investment benchmarks. It is common to look at the performance of a particular bond or stock index and then compare that performance with how your own investments did. But, is that really appropriate? If your portfolio is diversified and holds cash, bonds, U.S. stocks and also foreign stocks, it is very different than the Dow Jones average or the S&P 500 index – but once you've heard how your favorite benchmark performed, you get anchored to that number.

Anchoring is a great thing for a boat, but perhaps not so great for our brains.

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