Anchoring

Psychology of an Investor

Similar to how a house should be built upon a good, solid foundation, our ideas and opinions should also be based on relevant and correct facts in order to be considered valid. However, this is not always so. The concept of anchoring draws on the tendency to attach or "anchor" our thoughts to a reference point—even though it may have no logical relevance to the decision at hand.

Although it may seem an unlikely phenomenon, anchoring is fairly prevalent in situations where people are dealing with concepts that are new or unfamiliar.

A Diamond Anchor

Consider this classic example: Conventional wisdom dictates that a diamond engagement ring should cost around two months' worth of salary. Believe it or not, this "standard" is one of the most illogical examples of anchoring. While spending two months of salary can serve as a benchmark, it is a completely irrelevant reference point created by the jewelry industry to maximize profits, and not a valuation of love.

Many men can't afford to devote two months of salary toward a ring while paying for living expenses. Consequently, many go into debt in order to meet the "standard." In many cases, the "diamond anchor" will live up to its name, as the prospective groom struggles to keep his head above water in a sea of mounting debt.

Although the amount spent on an engagement ring should be dictated by what a person can afford, many men illogically anchor their decision to the two-month standard. Because buying jewelry is a "novel" experience for many men, they are more likely to purchase something that is around the "standard," despite the expense. This is the power of anchoring.

Academic Evidence

Admittedly, the two-month standard used in this example does sound relatively plausible. However, academic studies have shown the anchoring effect to be so strong that it still occurs in situations where the anchor is absolutely random.

In a 1974 paper entitled "Judgment Under Uncertainty: Heuristics and Biases," Kahneman and Tversky conducted a study in which a wheel containing the numbers 1 though 100 was spun. Then, subjects were asked whether the percentage of U.N. membership accounted for by African countries was higher or lower than the number on the wheel. Afterward, the subjects were asked to give an actual estimate. Tversky and Kahneman found that the seemingly random anchoring value of the number on which the wheel landed had a pronounced effect on the answer that the subjects gave. For example, when the wheel landed on 10, the average estimate given by the subjects was 25%, whereas when the wheel landed on 60, the average estimate was 45%. As you can see, the random number had an anchoring effect on the subjects' responses, pulling their estimates closer to the number they were just shown—even though the number had absolutely no correlation at all to the question.

Investment Anchoring

Anchoring can also be a source of frustration in the financial world, as investors base their decisions on irrelevant figures and statistics. For example, some investors invest in the stocks of companies that have fallen considerably in a very short amount of time. In this case, the investor is anchoring on a recent "high" that the stock has achieved and consequently believes that the drop in price provides an opportunity to buy the stock at a discount.

While it is true that the fickleness of the overall market can cause some stocks to drop substantially in value, allowing investors to take advantage of this short-term volatility, stocks quite often also decline in value due to changes in their underlying fundamentals.

For instance, suppose that XYZ stock had very strong revenue in the last year, causing its share price to shoot up from $25 to $80. Unfortunately, one of the company's major customers, which contributed 50% of XYZ's revenue, had decided not to renew its purchasing agreement with XYZ. This change of events causes a drop in XYZ's share price from $80 to $40.

By anchoring to the previous high of $80 and the current price of $40, the investor erroneously believes that XYZ is undervalued. Keep in mind that XYZ is not being sold at a discount; instead the drop in share value is attributed to a change to XYZ's fundamentals (loss of revenue from a big customer). In this hypothetical example, the investor has fallen prey to the dangers of anchoring.

Avoiding Anchoring

When it comes to avoiding anchoring, there's no substitute for rigorous critical thinking. Successful investors don't just base their decisions on one or two benchmarks, they evaluate each company from a variety of perspectives in order to derive the truest picture of the investment landscape.

It is never a bad idea to seek out other perspectives. Listening to a few "devil's advocates" could identify incorrect benchmarks that are causing a strategy to fail.

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