The Concept of Anchoring in Behavioural Finance

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Executive Summary: When you make a decision or evaluate any information based on a reference point which may not even be relevant to the decision, it is known as anchoring. Anchoring is a behavioural concept which is very common while evaluating both financial and non-financial decisions, especially those which are new or unknown. This distorts decision making. You can avoid anchoring by following critical thinking, sticking to investment principles and considering various perspectives before making a decision.

Imagine that you are shopping in a flea market, where one can bargain for a lower price. You wish to buy an exquisite piece of art which you see in one of the shops, but have no idea how much it is worth. The shopkeeper states an exorbitant price knowing fully well that you will bargain, as this is common practice. How much lower should you ask for the piece?

Common human behaviour is to seek a reference point while making a decision, although this reference point may be totally irrelevant. In this case, you may base your bargaining price to be a notch lower than what the shopkeeper quoted, although the actual worth of the product may be completely different. So this is your reference point. If supposing you had seen a similar piece of art in your friend's house, you may ask for a price close to what your friend paid for her piece, although the two may again be completely different pieces of artwork. In essence, you are anchoring your ask price based on some past event, although this is may be irrelevant (relevance in this case would be to determine the actual cost of making the art and adding a margin).

So what is Anchoring? In our previous post on behavioural finance, we had discussed that there are various behavioural finance concepts which affect logical decision making. Anchoring is one such concept in behavioural finance, wherein you make a decision or evaluate something using a fact or a past event as a reference, although this may have no logical bearing to the decision in question. All of us use anchoring in different walks of our life, either consciously or unconsciously, both in the areas of finance and otherwise. This becomes quite common when individuals evaluate decisions which are new or unfamiliar to them.

So how is this relevant in the world of investing? A common example is how investors make their decision to hold or sell a stock based on the past performances. To elaborate, suppose a stock had hit a lifetime high three months earlier due to a bull run in the stock markets in general. Today, the stock is trading 40% lower than this high price due to some intrinsic factors in the company, which are very material to the company's future performance. If an investor holds on to the stock on the expectation that it will go back to the highs it witnessed three months back, this means he is anchoring on an event which is not relevant to his decision. The stock may never go back to those levels because of a fundamental negative aspect in the company.

Another example of anchoring in the finance context is when investors rely solely on an expectation. Say you had purchased a stock at Rs. 100. Today the stock trades at Rs. 50. One analyst report states that the stock will double from current levels, while another report states that it will triple from current levels. Subsequently after 2 months, the company in question loses a large client leading to a further price correction. As an investor, you will want to hold on to the stock till it reaches Rs. 100 even though the fundamentals of the stock may not be strong. This is anchoring your decision based on a reference point quoted by report 1 and not taking into consideration the recent developments in the company. Now supposing the stock actually reaches Rs. 100, you may then decide to continue to hold on, till it reaches Rs. 150, as stated by report 2. Again, you are subjecting your decision to anchoring. In reality, the stock may not even cross Rs. 50 because of the changes in the future prospects. Instead of reducing your loss, you take a higher risk based on some irrelevant factors (in this case analyst reports which were released before the material event affecting future prospects).

The entry price on an investment usually acts as an anchor in taking future decisions. As discussed in the example above, the market price also becomes an anchor in many cases. Investors continue to rely on this despite knowing the irrelevance of the anchor factors.

So how do you avoid anchoring? Avoiding anchoring is anything but easy. However, rational and critical thinking can help in reducing the effects of anchoring. Do not rely on a single source of information. It is important to look at investment from all perspectives rather than simply look at past events associated with the investment. It is always useful to stick to investment principles such as asset allocation, risk diversification and goal based investing when evaluating investments.

While the above post is original, concepts have been reviewed from Investopedia.com and other websites.