

Anchors – Don't be Caught by One

In our culture we have been conditioned to accept the marked price of goods. While it is necessary to negotiate on big ticket items like cars and houses, we tend to think that there is little practical scope to negotiate prices in most stores. However, when travelling overseas we will encounter different cultures. Many Australians have difficulty dealing with merchants for whom every price is negotiable. This is because the merchant will employ one of the oldest and most difficult to counter biases: anchoring.

Consider Margaret. She was travelling in Mexico and was attracted to the myriad handicrafts being sold in shops and in the street. Margaret had no concept that the price of everything in this environment is negotiable. She was accustomed to a simple decision-making regime. If she could not see the price on the item, she screwed up her courage and asked what it was. From there it was easy – Margaret was either prepared to pay the price asked or not.

On the one hand, this approach might have been fine. After all, the object she was buying was clearly judged to be worth the price to her. However, it is rarely that simple. Once she returned to her hotel and mingled with the other tourists, she found out that many of them had bought the same or similar trinkets for much less than Margaret had paid. This set off feelings of shame and inadequacy that she had been foolish enough to pay what she had.

What had happened here was anchoring. It is simple, but very effective. In this economy, the merchant's asking price will invariably be much higher than the real market price. Instead, the price asked by the woman in the shop will be commonly known as the tourist price. Unless Margaret has done her research on competing stores and knows what the going rate is, she will be trapped by the asking price. Even if she has a rough idea of the real price the woman in the shop will sell for, she will have great difficulty accepting the initial asking price as a starting point for negotiation. She will doubt her own judgement. She will think it rude to argue about the price.

So, in this environment westerners have a great disadvantage. We are not accustomed to doing business this way. It may take us a while to even realise what is happening: at least until we get back to the hotel and are wised up by more savvy travellers who understand the local markets.

Indeed, anchors are so pernicious that, even if we know the asking price is likely to be an anchor, it will not help us unless we have some idea what the right price should be and the right price is never clearly defined anyway.

Obviously, the key to dealing with anchoring is to recognise it. Then Margaret needs to do her research, so that she has a factual basis for negotiation. However, even if Margaret has worked out that the reasonable price for the item is \$100 and the woman in the shop's starting price is \$300, it is fatal for Margaret to try to negotiate her down dollar by dollar from the anchor price. That is playing her game and she will beat Margaret at it every time.

Instead, Margaret should offer \$30. Expect the woman in the shop to politely scoff at this price. However, Margaret has signalled that she is not fooled by the anchor price asked. She might even

make a move to leave the shop and buy elsewhere, where the price is more reasonable. Now the bargaining starts in earnest. Margaret should persist in forcing the sales woman to justify any price more than \$30, which she will attempt to do by showing off all its qualities. The owner of the shop might also be brought in to help with the selling. Margaret should be reasonable, but firm and persist with replacing the asking anchor price with the anchor of her own.

This is a psychological game that is played hard for what seem to us to be small stakes. However, it is not small stakes to the merchant. The sales woman will even enjoy the cut and thrust of bargaining, always politely conducted, but with an underlying serious side. Margaret should also be polite, but firm, in her determination to not pay too high a price. In the end, Margaret must be fair. She must be prepared to shop elsewhere. Haste in buying works against her strongly. However, in the last resort, Margaret must be prepared to live publically with the price she finally agrees to pay.

The anchoring bias is prevalent in almost anything we do, but especially in investing decisions. In an economic recession, prices will be low. The offer price for a stock may represent good value. If we know it is good value, we can make a good decision. However, if some years later there is a bull market, prices will be well above sound value. For beginning investors, who don't know how to assess value on a broad perspective, the high prices on offer act like an anchor. A stock is offered at \$5. Its price slips a bit and they buy it for \$4.70. They think they have a bargain. But if the realistic value is only \$2, they have been fooled by the anchor price.

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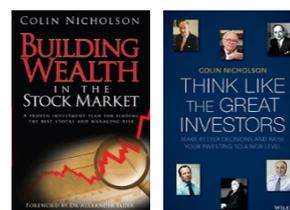
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