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Focus on FINANCE

The Anchoring Effect

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GLOSSARY

Anchoring effect: The tendency for a person to rely heavily on the first piece of information they receive when making decisions.

Cognitive bias: A systematic error in thinking that affects people's judgment and decisionmaking.

Opportunity cost: The value of the next-best alternative when a decision is made; it's what is given up.

> "Which would you buy? A dress shirt priced at $60 or the very same dress shirt, priced at $100, but 'On Sale! 40% off! Only $60!'?"
> —Dan Ariely and Jeff Kreisler[1]

Anchoring

How many times do you say, "Wow, that is expensive! I know it costs a lot less at the other store"? Or "Wow! Check out this steep discount!" The importance of a good deal is on many consumers' minds when they purchase goods and services. How do consumers decide if something is a good deal?

Whether online or in a physical store, shopping around for a good or service usually involves constant reference to the prices. However, it's the *initial* price a consumer is exposed to that becomes a consistent reference point when shopping around. The tendency for a person to rely heavily on the first piece of information they receive when making decisions is known as the **anchoring effect.**[2] The anchoring effect is a type of **cognitive bias**—a systematic error in thinking that affects people's judgment and decision-making. Anchoring plays a role in decisions that involve numerical values such as prices.[3]

Anchoring Is a Type of Cognitive Bias

People often use heuristics, or mental shortcuts, to make decisions. For example, when making a budget, people often rely on the following heuristic: "I'll save 10 percent of my income while I am working so that I have emergency funds to pay for daily expenses if I lose my job." While heuristics can help people make decisions quickly, they can lead to cognitive biases that limit the information they should consider when making shopping decisions. The anchoring effect is a type of cognitive bias because people tend to rely on their first piece of information, and they can either decide too quickly and fail to shop for better prices or overlook other information, such as the quality of the product.

Price anchors are a type of heuristic that offer consumers an easy and familiar starting point. No one likes to make difficult choices or challenge themselves all the time, so the ease and familiarity of anchoring make this process more appealing and influential than people may think. Consumers

Are Arbitrary Numbers Powerful Anchors?

Experiment 1: In a 1974 study conducted by Tversky and Kahneman, participants were shown a spinning wheel. When the wheel was spun, the participants saw the number it landed on. They were then asked to guess if the number was higher or lower than the percentage of African nations in the United Nations. Group A saw an arbitrary number of 10, and Group B saw an arbitrary number of 65. The median estimate in Group A was 25, and in Group B it was 45.

Experiment 2: With a group of MBA students at MIT, Dan Ariely and a fellow professor experimented to see if the last two digits of a Social Security number would serve as price anchors. Students were asked how much they were willing to pay for two types of wine, a cordless mouse, a cordless keyboard, a design book, and chocolates. The professor instructed students to write down the last two digits of their Social Security number at the top of the page and then write them again as a price next to each item. So, if the last two digits were four and five, the student would write $45. When they finished that task, students were asked to indicate for each item "yes" if they would pay that price or "no" if they would not pay that price. As the last step, students wrote down the maximum amount they would be willing to pay for each item. Ariely found that students' Social Security numbers influenced the amount they were willing to pay. Students with the highest last two digits of their Social Security number (80-99) bid highest, and those with the lowest last two digits (1-20) bid lowest. When students were debriefed on the experiment and asked if they thought their Social Security numbers influenced the prices they were willing to pay, they stated no.

SOURCE: Ariely, Dan. *Predictably Irrational: The Hidden Forces That Shape Our Decisions, Revised and Expanded Edition*. HarperCollins, 2010. Tversky and Kahneman, 1974; https://doi.org/10.1126/science.185.4157.1124.

also generally trust themselves, which is why anchors feel acceptable, relevant, and well-informed.[4]

Price Anchoring

Retailers are very aware that price anchors are an effective tool they can use in their pricing strategy. The price tags on goods in many retail stores often state the manufacturer's suggested retail price (MSRP). For many people, the MSRP becomes the reference point (anchor) that drives subsequent decisionmaking. According to behavioral economist Dan Ariely, consumers are bombarded by prices. However, the price itself is not necessarily the anchor. The price becomes an anchor only when the consumer contemplates buying the good or service at the stated price. When comparison shopping, consumers see there is a range of acceptable prices. Still, like a bungee cord, consumers always refer back to the original anchor. As a result, immediate buying decisions, and many others that follow, are influenced by an original anchor.[5] Retailers set prices knowing consumers think about prices relatively (boxed insert, "Are Arbitrary Numbers Powerful Anchors?").

Online shopping is a way for consumers to shop around for the same or comparable items with ease. For example, imagine that someone is planning to buy a smartwatch, and the first price they see online is $250. It is a watch they want, and therefore that first price becomes the anchor. From that point forward, every other smartwatch is compared relative to the $250 price point. Consumers enjoy comparing and valuing goods and services, and the anchor price allows them to do that.

In another scenario, a store may have three types of smartwatches that are comparable. Let's say that the difference between each watch is its size and the quality of the wrist band. The largest size with a leather wrist band costs $900; the next size down with a stainless-steel wrist band is $750; and the smallest size with a woven nylon band is $700. In this case, someone will likely think that the $750 watch is the best deal because it is not the cheapest, it is not the smallest, and it costs $150 less than the most-expensive one. Behavioral economists point out that retailers intend for customers to ponder a purchase this way. The $900 watch is the anchor; therefore, the $750 watch seems like a bargain in comparison. The $750 option feels good because it is not the most expensive, while at the same time it is not the least expensive and is of decent quality. It is a thought process like this one that humans tend to veer toward because of cognitive bias. Consumers tend to go for the most-rewarding item that requires the least money/effort.

Presentation is Everything

As mentioned earlier, retailers set prices knowing that consumers think about costs relatively. Some retailers never intend to charge the written MSRP; instead, their intended outcome is for the consumer to pay the sale price. They "anchor" the buyer to a higher price. Once

the buyer is anchored at the higher MSRP, the lower advertised sale price seems and feels like a good deal. Ever hear the saying "presentation is everything"? A very true statement when it comes to promoting goods and services to consumers. Influencing consumers' purchasing decisions depends on how the information is presented (framed). Let's look at the advertisements for winter jackets (Figure) and think about how they make you feel about the deal you are getting. Does the first ad make you feel like that jacket is a great deal? Probably not. How about the second? If you were shopping for a jacket and saw the initial price of $120, then the $55 seems like a great deal, right? The savings is more than 50 percent. That deal cannot be passed up, even if you live in a warm climate! How about the third advertisement? This one provides an anchor of $120, plus it reinforces this notion of a great deal with words like "lowest price guaranteed!" Advertisements such as these can influence buyers to purchase the jacket just for the satisfaction of feeling like they got a good deal. This can be the case even if it is an item they may not use. Again, it's a deal that is too good to pass up.

How to "Beat" Anchoring

Shopping around at other retailers to know the approximate price of the good or service in the market can help you find information beyond what is immediately available. This way, a buyer can recognize that the advertised discount is a low price relative to others and that it's not just marketed to seem like one. Anchoring also plays a significant role in negotiation, whether for a car or a pay increase. When negotiating for a vehicle, for example, a buyer can set the anchor by being the first to make an offer. And, if the negotiations aren't going well, walking away from them could reset the anchor.

Buyers can also take a moment and reflect on how much they value the good or service. Regardless of how good the sale price seems, consumers should think beyond the good or service that money can buy now and consider what that same amount of money can buy in the future. This type of thinking involves considering the **opportunity cost**—the value of the next-best alternative when a decision is made; it's what is given up. In other words, consumers should not just consider the choices present at the time but think beyond that, while keeping in mind that money can only be spent once. When shopping online, consumers can add items to a virtual shopping cart but not buy them until later, maybe sleeping on it before hitting the "buy it now" button.

Conclusion

Thinking deliberately about every decision we make is exhausting. People use heuristics to make judgments about the world around them. Using heuristics is not about making the correct or incorrect choice; it is about deciding quickly. Using mental shortcuts to get what is wanted takes less effort and makes shopping more fun. Behavioral economists state that retailers know this and are aware of the satisfaction consumers get from a good deal. Anchors often set the price we are willing to pay for a good or service.

And, as the three advertisements for the same jacket demonstrated, the presentation (framing) of an anchor impacts how effective the anchor is. Consumers love bargains, and when something is presented as a good bargain, consumers are more willing to make the purchase. It is all relative to a reference point that helps consumers decide if something is "cheap" or "expensive." While anchors are not entirely avoidable, a bit of strategy when making a purchase can help consumers see beyond the anchor. Remember that numbers are arbitrary until they become the reference point (anchor) when deciding about a purchase or even when making a numerical guess. ■

Notes

[1] Ariely, Dan and Kreisler, Jeff. *How We Misthink Money and How To Spend Smarter*. HarperCollins, 2018.

[2] Modified from Zdanowicz, Craig. "Designing Choice: The Default, Anchoring, and Loss Aversion." August 22, 2015; https://medium.com/@craigzdanowicz/designing-choice-the-default-anchoring-and-loss-aversion-5223265f050.

[3] Taylor, Jim. "Cognitive Biases Are Bad for Business: Do You See Irrationality in Your Company?" *Psychology Today*, May 20, 2013; https://www.psychologytoday.com/blog/the-power-prime/201305/cognitive-biases-are-bad-business.

[4] Ariely and Kreisler, 2018. See footnote 1.

[5] Ariely, Dan. *Predictably Irrational: The Hidden Forces That Shape Our Decisions, Revised and Expanded Edition*. HarperCollins, 2010.

Name____ **Period**________

Federal Reserve Bank of St. Louis *Page One Economics*®:

"The Anchoring Effect"

After reading the article, answer the following questions:

1. Dawn wants to buy a new house, and the first one she sees is priced at $300,000. As she continues her search, she always refers back to the first price she saw. This describes an example of
   a. the ownership effect.
   b. the anchoring effect.
   c. opportunity cost.
   d. the boomerang effect.

2. Which of the following best describes why people use heuristics?
   a. Heuristics make decisionmaking more challenging.
   b. Heuristics make people aware of the right or wrong choice.
   c. Heuristics can help people make decisions quickly.
   d. Heuristics prevent people from deciding too quickly.

3. Anchoring is a type of
   a. retail price.
   b. price range.
   c. decisionmaking.
   d. cognitive bias.

4. What is one of the downsides to using heuristics when making a decision?
   a. People can overlook other information.
   b. The optimal decision is always considered.
   c. It makes decisionmaking a longer process.
   d. It makes people rely on too much information.

5. A price tag states that an item's MRSP is $100 but that its markdown is $40. This is an effective sales strategy because
   a. discounts anchor buyers to the lowest price, so they are willing to pay more.
   b. the buyer is anchored to the higher price, so the lower price feels like a good deal.
   c. a higher price is a reference point that is never considered again.
   d. retailers know that consumers do not think about costs relatively.

6. If they rely on anchors, consumers will likely choose which of the following?
   a. The top-quality product at the highest price
   b. The middle-quality product at the middle price
   c. The lowest-quality product at the lowest price
   d. The lowest-quality product at the highest price

7. Faith is negotiating the price of a used car she wants to buy. What is one strategy she can use to beat anchoring?
   a. Ask the seller what the maximum price is.
   b. Walk away before making an offer.
   c. Offer to pay in cash.
   d. Be the first to make an offer.

8. Arbitrary numbers can be effective anchors.
   a. True
   b. False

9. At what point does a price become an anchor?
   a. When a consumer considers purchasing the good at the stated price
   b. When a consumer looks once at the price and forgets they ever wanted the good
   c. When the consumer sees the good advertised everywhere they shop
   d. After the purchase has been completed

10. Retailers always intend that consumers pay the MSRP.
   a. True
   b. False