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WEALTH MANAGEMENT

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Term of the Week- Anchoring

For the next few months we will be looking at terms often found in behavioural finance, and this week the term is *anchoring*.

Anchoring a behavioural bias where an investor uses an irrelevant or arbitrary piece of information on which to base a decision.

Anchoring is particularly dangerous in financial markets because it can lead to negative (or less than optimal) outcomes. There are various forms of anchoring, some of which I will detail below. It is also important to note that anchoring is not limited to financial markets but is encountered in everyday life.

In order to reduce the effect of anchoring, investors must base their decisions on a wide range of objective data points and question the underlying assumptions behind this data.

It is particularly important to be aware of anchoring in the present market environment as markets can often appear in limbo. US ten year treasury yields, for example, have been deemed high (as they rose above 4.50% in May). If we look back through history, however, yields were above this level from 1965 all the way to 2003 and the average monthly yield was 5.84%.

Investors are anchoring on both the numerical figure of 4.50% and the short term nature of the data to drive their conclusions, and not looking at sufficiently long term data. The more important point that is the direction of travel of yield values, not the absolute value.

Technology stocks are also a minefield for anchoring biases, Tesla being a prime example. Trading at a forward Price/Earnings ratio of 140, investors are anchoring on the fact Elon Musk is the CEO and therefore because he has been successful in the past, he will be successful in the future.

Examples

- Basing a forecast of a future stock price on its current stock price.
- Anchoring to a certain value of an index. For example, the S&P 500 index price pushes through 6000 points, and assuming it therefore must continue upwards from this point – and all forecasts being based on the 6000 value, ignoring historical standard deviations.

- Buying a stock for say, £10, and then referencing any selling decisions to the £10 purchase price even though it does not reflect any fundamentals. This can result in holding over valued stocks for too long and retaining the paper losses.
- Anchoring features heavily in technical analysis. If the price chart for a stock follows a certain pattern it represents a buying or selling opportunity.
- In everyday life, if we buy a new car and the starting price is £50,000, the tendency is to anchor on this price – even though the actual price of the car may be say, £10,000. A discount of £5,000 from the higher price will then look like good value even though the car is still overpriced.

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