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Simon Russell is the founder and director of Behavioural Finance Australia. He provides specialist behavioural finance training and consulting to financial advisers, fund managers and major superannuation funds. Simon's most recent book, *Behavioural finance: a guide for financial advisers*, is intended to help financial advisers to prepare for the behavioural-finance-related components of the FASEA exam, and improve their client engagement skills.

Using anchoring in negotiations

When and how

Simon Russell

My most popular behavioural finance workshop series have been on negotiations. The participants in these workshops were typically teams of private equity investors and venture capitalists, or corporate mergers and acquisitions teams. These are smart people. They typically have plenty of high-stakes negotiations experience. That is what they do for a living.

Therefore, these sessions are not supposed to be Negotiations 101. Rather, the purpose is to help participants to apply insights from psychology to reach better negotiated outcomes. How can they better influence their negotiating partners and better manage their own negotiating blind spots?

A few million dollars-worth of anchoring

The single most powerful and reliable psychological effect that I talk to participants about is anchoring. Psychological research shows that anchors can significantly impact people's decisions. Further, negotiations research confirms that anchors can impact negotiations in particular.

When the results of one of the negotiating exercises I run with workshop participants are posted on the whiteboard, they typically show the same effect. That is, the impact of anchoring is strong, even among these sophisticated and experienced negotiators. The purchase prices they agree for a hypothetical pharmaceuticals factory vary by millions of dollars, depending on who uses the first anchor in the negotiation.

Initial bids/offers as anchors

Some people are reticent about putting a number on the negotiating table that could serve as an anchor. They fear that their initial bid might be so high as to be accepted gleefully, or so low as to be rejected out of hand. These risks are real, so these participants' fears are genuine. It is dangerous to be the first to move if a person has little idea whether their bid or offer will be perceived as substantially too high or too low.

Example 1. Inadequate knowledge and making the first move

Buying a technology start-up can be used as an illustration. Is it worth zero, or perhaps a billion? It is easy to be wrong by an order of magnitude. Going first in this type of negotiation could be dangerous.

However, these risks should not stop people using anchors to their advantage in situations where they have a good understanding of the negotiating range.

A person is less likely to be wildly wrong when valuing a particular asset or service when they have expertise and recent experience valuing

similar assets and services, or a number of directly comparable transactions as benchmarks, or their valuation is underpinned by readily marketable assets and services.

While there is always some uncertainty in a negotiation, and gauging the amount of that uncertainty can sometimes be difficult, workshop participants do have some of these types of information about the hypothetical pharmaceuticals factory. Nobody's valuations are radically too high or low. Something else is making them reluctant to go first.

What is a good outcome?

Part of the problem is that people tend to judge the success of a negotiation by the other party's response. Research shows that if a counterparty accepts our offer immediately, we tend to feel less satisfied with the outcome than do other negotiators who achieved objectively inferior results but whose offers were not immediately accepted. It can feel better to fight for a bad outcome than to be handed a good one.

The problem is that winning too easily leads people to feel regret, and to the sense that they could have done better. However, trying to avoid this regret by not using anchors can lead to objectively worse negotiated outcomes.

Given the power of anchors, we should worry less when we have a strong basis for our valuation. We could mitigate the risk of future regret by asking the other party to tell us their valuation expectations first, but in doing so we simply allow them to anchor the negotiation in their favour.

Informal uses of anchors

When there is significant uncertainty, and when real dangers of using anchors as part of formal bids or offers exist, there are many other ways anchors could be used in a negotiation.

Example 2. Displaying knowledge informally

One way is to use anchors as part of informal discussions. A price expectation, a past transaction value, a historic share price can be casually thrown into a conversation or discussion without the risk of it being formally accepted or rejected.

Psychological research shows that particular values do not even have to be directly relevant to impact people's decisions. However, while citing the last three digits of one's phone number, spinning a pin-wheel or rolling a pair of dice might significantly impact people's decisions in psychological experiments, it is not worth risking undermining trust and credibility by using clearly extraneous methods in a real-world negotiation.

Anchors, anchors everywhere

While the purchase price is typically the most visible number to be negotiated, it is probably just one of many. Arguably, before each time one of these numbers is negotiated, a favourable anchor should be applied.

Example 3. Using favourable anchors

A vendor could say, 'The average market growth rate is 10%, but our projections assume 6%,' or 'The replacement value of the assets is $50 million, but we've got them in the books at $45 million.'

A purchaser could say, 'Our valuation is based on maintaining a stable management team for five years, but we're only asking them to commit for three.'

Arguably, many of these ancillary amounts are subject to less scrutiny and critical analysis than the overall price, making them more ready targets for the influence of anchors. Each time the other party fails to employ effective countermeasures against the anchor, their decisions are likely to be influenced, often substantially.

Case study: The influence of reference points

The following case study is reproduced from *Behavioural finance: a guide for financial advisers.*

"A few years ago, I tested the impact of anchoring on financial advice fee estimates with a group of around 400 financial advisers. The advisers completed a short survey in which half of them were asked, 'How much do you think the average investor spends on financial advice (including financial planning, stockbroking and tax advice) each year? Is it above or below $500?' and then 'What is your estimate?' The other half of the group received the same questions, but with '$500' replaced with '$2,000'.

"It was expected that the advisers' estimates would be heavily influenced by the $500 and $2,000 anchors. This is what happened. The estimates provided by those who had seen the high anchor were, on average, 65% higher than the group who saw the low anchor ($2,077 versus $1,257). If financial advisers' estimates were heavily influenced by anchors, then less-informed clients, who face more uncertainty about the value of financial advice and who are probably less able to bring to mind alternative anchors, are likely to be even more influenced."

Sometimes people naturally craft their communications using anchors, but sometimes not. Sometimes anchors are communicated by a senior investment banker who is familiar with their implications for a transaction. However, sometimes important information is communicated by a junior analyst who runs the financial model, and who is not totally conversant with it. Therefore, it is important that everyone involved in the transaction should have at least a basic understanding of the power-

The quote

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ful impact of anchoring. When anchors can change transaction outcomes by millions of dollars, it pays to use them wisely.

This begs a deeper question. That is, is our sense of value primarily underpinned by our own independent analysis of the asset in question, or by the value our counterparty perceives? It is highly likely that most participants would argue the former—that their valuation is based on their own detailed due diligence, their valuation models, etc. However, when it comes to how happy we feel with the result of a negotiation, our counterparty's perceptions appears to play a greater role than many negotiators might expect. **FS**