

The Impact of Anchoring Effect on Financial Investment Decisions and Coping Strategies

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Abstract: The development of behavioral finance has resulted in a heightened emphasis on the impact of psychological elements on investment decision-making, which has emerged as a key domain of academic inquiry. In particular, the anchoring effect is widely used in consumer behavior as a common cognitive bias. However, its application and research in the financial market remain insufficient, especially in terms of the underlying mechanism of action and optimization strategies in different market environments. Therefore, this paper aims to explore the impact of the anchoring effect on investors' decision-making processes with regard to stock valuation, portfolio selection, and trading strategies, and analyze the potential for adjusting this cognitive bias in order to improve decision-making quality and investment returns. Through a combination of literature review and case study, we explore the performance of the anchoring effect in different investment decisions and its mechanism of action, and propose strategies to deal with it. The results show that the anchoring effect significantly affects stock valuation, portfolio decisions and trading strategies. Investors often rely excessively on initial information, such as historical stock prices or market highs, leading to erroneous investment judgments. And this bias is particularly pronounced during times of high market volatility, and may lead to missed market opportunities or irrational decisions, which further affects investment returns.

Keywords: Anchoring Effect, Stock Valuation, Investment Decision, Behavioral Finance, Cognitive Bias

1. Introduction

In investment decision-making, psychological factors influencing investor behavior have emerged as a significant area of academic research in recent years. The anchoring effect has been the subject of early research in the field of consumer behavior and approximately half of the decision-making field. However, there is little systematic research on the practical application of the anchoring effect in financial markets, especially its application in different market environments, its mechanism of action and strategy optimization. At present, pertinent research is concentrated on the identification and quantification of the anchoring effect, as well as the development of decision-making strategies that can optimize this cognitive bias. Thus, the paper employs a qualitative approach, combining a literature review with case studies, to investigate the impact of the anchoring effect on investors' decision-making processes in stock valuation, portfolio selection, and trading strategies. Also, it seeks

to provide an in-depth analysis of how the anchoring effect affects investors' decision-making, and investigate how the anchoring effect can be adjusted to enhance decision-making processes and improve investment returns. The results demonstrate that the anchoring effect exerts a significant influence on stock valuation, portfolio decision-making, as well as trading strategies. As such, it can be effectively integrated with related risk management and coping strategies to augment the intelligence and rationalization of market decision-making.

2. Overview of the Anchoring Effect

The anchoring effect is a cognitive bias characterized by the tendency of individuals to rely excessively on initial information or anchors when making decisions, even when such information is irrelevant to the final decision. Initial reference point has a significant influence on subsequent judgments and estimates, which often results in biased and suboptimal decisions. To illustrate, a consumer who initially observes a price of \$100 and subsequently encounters a reduction to \$50 may perceive the latter as a favorable offer, despite the initial \$100 price point being arguably unjustified. The phenomenon demonstrates that individuals frequently fail to adequately adjust their initial anchoring during the decision-making process. This bias is particularly pronounced in the context of uncertainty or complex decision-making scenarios. The concept was first introduced by psychologists Amos Tversky and Daniel Kahneman in 1974, whereby they revealed an irrational bias in individual decision-making, thus challenging the assumption of rational decision-making in traditional economic theory [1].

In behavioral finance, the anchoring effect has been demonstrated to exert a significant influence on investment decisions. Investors frequently utilize the initial stock price as a reference point, often insisting that the stock should revert to its previous price even in the face of evolving market conditions. This proclivity for relying on initial information can result in the forfeiture of market opportunities or the formulation of irrational decisions, which in turn can impact portfolio returns. To illustrate, an investor may purchase a stock for \$50 and subsequently assume that the value of the stock should revert to that level. In the event of a decline in the stock price, the investor may be disinclined to accept the legitimacy of the market adjustment and may instead place undue reliance on the initial purchase price. This can result in the investor failing to acknowledge the actual change in the market, which may ultimately lead to losses [2]. An understanding of the anchoring effect can assist investors in making more rational and data-driven decisions and in avoiding the making of poor investment judgments based on historical prices or outdated information.

The formation of the anchoring effect can be explained by three aspects: cognitive biases, mental accounts, and decision-making frameworks. In complex and uncertain situations, investors tend to rely heavily on the initial information provided as a reference point. In addition, individual decision makers categorize the information into different "mental accounts", which subsequently influence subsequent decisions. By the tenets of Decision Framing Theory, decision-makers evince disparate behavioral patterns in response to disparate scenarios and frameworks. They are susceptible to the anchoring effects of current market conditions or historical prices, which may constrain their actions and create analytical biases.

3. The Anchoring Effect on Financial Investment Decisions

3.1. The Anchoring Effect on Stock Valuation

Investors frequently place excessive reliance on historical prices in stock valuation, neglecting to consider market fundamentals in their decision-making processes. This tendency is particularly evident during times of significant price volatility. Investors often utilize historical price peaks or troughs as benchmarks to shape expectations regarding future price movements, which may not align

with underlying realities. As a result, evaluating stocks and making informed decisions can be challenging in the face of uncertainty. Price points to which investors anchor may mislead, affecting buying and selling decisions and distorting rational judgment. For instance, when a stock price reaches \$100, investors may view the stock as undervalued, overlooking essential elements such as market dynamics, company fundamentals, or prospective growth. This could result in erroneous assessments and overconsumption. Before implementing market stabilization measures, such as interest rate reductions, a corporation may augment its activities, leading to a transient enhancement of its financial performance. However, when the market overheats and interest rates rise, borrowing costs for companies increase, which can harm their operations and affect stock prices. Research has shown that investors are often influenced by initial or available information when valuing stocks, especially in uncertain markets. De Bondt and Thaler found that investors tend to overestimate the future performance of stocks that have recently risen and underestimate the potential of stocks that have fallen, contributing to market overreactions and inefficiencies [3].

For example, regulatory pressures on Alibaba in 2020 and 2021 led to a sharp decline in its share price, which fell below \$200, a 40% decline from its prior high of \$319 in October 2020.³ The company's share price is still undervalued. Despite the change in the company's fundamentals, many investors may still be anchored to the peak price of \$319, believing the current price is undervalued. This mindset has encouraged some investors to buy more shares in hopes of a rebound [4]. The anchoring effect also affects financial analysts and institutional investors. Over-reliance on past prices and forecasts can lead to overreaction, distorting price discovery and market efficiency. And investors should use varied information sources and modify psychological criteria to avoid this cognitive bias. Investors can avoid the anchoring effect by focusing on long-term potential and risk rather than previous highs.

3.2. The Anchoring Effects on Portfolio Decision Making

In the field of portfolio management, the anchoring effect has been shown to influence key aspects such as asset selection, risk assessment, and asset allocation. For instance, investors may anchor their decisions on the historical performance of a stock or its initial purchase price. Even if the business's fundamentals deteriorate, an investor may be hesitant to sell a stock that has risen since purchase. Inefficiencies in the market may result from skewed logical decision-making caused by this cognitive bias [5].

One manifestation of the anchoring effect is “loss aversion,” where individuals feel the pain of losses more acutely than the pleasure of equivalent gains. This tendency often results in risk-averse behavior, with investors overly focused on avoiding losses rather than pursuing potential gains [6]. This bias, known as the “disposition effect,” can cause investors to hold onto underperforming assets for too long, rather than reallocating resources to higher-quality, growth-oriented investments [7]. In some cases, investors may even sell their high-performing assets prematurely, fearing losses or to lock in short-term gains. The anchoring effect was particularly evident during the dot-com bubble. Between 1999 and 2000, the price-to-earnings (P/E) ratios of many technology stocks soared, with the NASDAQ Composite Index reaching a P/E ratio of 70 at its peak, well above the historical norm of 20 to 25 [8]. Despite inflated valuations, many investors retained an optimistic outlook, anticipating additional price increases. Despite the market crash and the subsequent bubble burst, many investors maintained the belief that stock prices would ultimately recover to their pre-crash levels, exacerbating their losses.

To mitigate the influence of the anchoring effect, investors should periodically assess their portfolios to ensure they match market conditions and long-term goals. Prompt adjustments to their “anchors,” such as historical price points or valuation benchmarks, can help prevent excessive reliance on outdated information. For long-term value investors, price anchors can serve as a useful

tool during market downturns, helping to avoid panic selling and preserve the potential for future gains.

3.3. The Anchoring Effect on Trading Strategies

The anchoring effect plays a crucial role in asset pricing, market forecasting, and the development of trading strategies. It often leads to market inefficiencies, such as mispricing of assets, bubbles, and crashes. Traders and financial analysts must recognize and mitigate the anchoring effect to enhance market stability and improve decision-making accuracy.

In market forecasting, participants frequently anchor asset valuations to historical prices, overlooking changes in underlying factors. This cognitive bias can create overconfidence, leading to herd behavior and contributing to market distortions, such as price bubbles or sudden crashes. For instance, an investor may overestimate the value of a stock by relying solely on its historical performance, neglecting to consider changes in its fundamentals. However, savvy investors can leverage this effect by identifying situations where assets are undervalued or overvalued due to anchoring, gaining an advantage in the market.

Psychological pricing strategies also highlight the anchoring effect. A common tactic in retail, such as Amazon's pricing model, demonstrates how historical prices shape consumer perception. By displaying an original price (e.g., \$200) next to a discounted price (e.g., \$150), Amazon creates an anchor that makes the discount appear more attractive, even if consumers would be hesitant to pay the original price [9]. When applied to trading techniques, this psychological manipulation has the same effect on consumers as it does on their purchasing decisions. In trading, the anchoring effect distorts decision-making by influencing traders' perception of an asset's fair value. Historical prices and psychological price points can act as anchors, skewing judgments and leading to suboptimal investment choices. Understanding this bias and incorporating it into strategy development is essential for improving accuracy and avoiding potential market pitfalls.

4. Coping Strategies for the Anchoring Effect

4.1. Investor Awareness and Cognitive Intervention

The first step should be to raise investors' awareness of the existence of cognitive biases in financial decision-making. Investors must identify instances in which they are influenced by irrelevant reference points, such as arbitrary benchmarks or initial stock prices. One effective approach is through self-reflection techniques, where investors consciously assess their past decisions and identify instances where anchoring may have played a role. Furthermore, cognitive training can help individuals develop critical thinking skills, enabling them to question their assumptions and resist biased judgments. Psychological interventions, such as mindfulness and cognitive-behavioral strategies, can also help reduce the automatic response to anchors, promoting more objective and rational decision-making. By fostering greater self-awareness and incorporating these cognitive interventions, investors can mitigate the impact of anchoring and improve the accuracy of their investment decisions.

4.2. Information Presentation Optimization and Decision-Making Framework Adjustment

Improving the presentation of information to investors is another important tactic to combat the anchoring effect. According to studies, decision-making can be greatly impacted by the way data is presented and the context in which it is received. To minimize the influence of anchors, presenting information in a way that emphasizes multiple perspectives and diverse data points can help reduce reliance on any single anchor. For example, providing a range of possible outcomes or focusing on

relative valuation metrics rather than absolute values can encourage investors to make more informed choices [10]. It is also possible to reduce anchoring bias by changing the decision-making framework. Investors are less likely to base their decisions on inappropriate starting points when decision-support tools are used and a systematic evaluation process is encouraged, for example, by evaluating different investment possibilities across different aspects. These strategies can enhance rational decision-making by breaking the cognitive hold of initial reference points.

4.3. Future Research Directions and Practical Applications

There are a number of interesting directions that could lead to more research into the practical consequences of anchoring effects in the financial sector. In more complicated situations, future studies could investigate the ways in which anchoring influences investor behavior in conjunction with other biases, such as loss aversion and overconfidence. In addition, there is a need for studies examining the role of anchoring in different asset classes and market conditions, as well as its impact on long-term investment strategies. Practical applications of this research are particularly important in areas such as risk management and policy-making. For instance, financial institutions could develop tools or frameworks that help identify and adjust for anchoring biases in portfolio management, ensuring more accurate risk assessments. In terms of policy, regulators could design interventions to nudge investors toward more rational decision-making, such as setting guidelines for the presentation of financial data. As far as behavioral finance is concerned, these insights contribute to the development of more effective investment strategies that take into account the psychological tendencies that influence market behavior, and ultimately contribute to the stability and efficiency of financial markets [11].

5. Conclusion

The paper examines the anchoring effect and its implications in behavioral finance, with a particular focus on stock valuation, portfolio decision-making, and trading strategies. The anchoring effect occurs when individuals rely excessively on initial information or anchors, thus resulting in biased judgments and decisions. In the context of stock valuation, this bias can result in the overestimation or underestimation of a stock's current value, with the consequence that its intrinsic worth is overlooked and flawed investment choices ensue. In the context of portfolio management, the anchoring effect has the potential to influence asset allocation decisions. Investors may place undue emphasis on past performance, overlooking future prospects. This could result in the distortion of diversification strategies and an inaccurate assessment of risk tolerance. Similarly, in the context of trading, reliance on historical support or resistance levels can result in traders failing to take into account macroeconomic changes or unexpected market events, thereby impairing their ability to predict future price movements accurately. While this research highlights the pervasive role of anchoring in financial decision-making, it also acknowledges the need for further investigation. One limitation of this research is that it is challenging to isolate the anchoring effect in real-world scenarios, as it often interacts with other cognitive biases. More study should look at how individual traits including personality and investor experience affect sensitivity to anchoring. Furthermore, one may investigate how technical developments, such as algorithmic trading, may either reduce or increase the anchoring bias. Improving decision-making and lowering financial risks in the markets depend on an awareness of and solution for the anchoring effect.

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