Proceedings of the 4th International Conference on Business and Policy Studies
DOI: 10.54254/2754-1169/168/2025.21774

The Applications of Anchoring Effect in Business Activities

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Abstract: The anchoring effect is an important theory in behavioral economics, which has aroused much attention and been widely utilized in the economic market. By far, much research and experiments have been done to show the mechanism, types and applications of the anchoring effect. In this essay, the meaning, mechanisms and especially the applications of anchoring are discussed and analyzed by a case study method. The following discussion mainly focuses on the applications of the anchoring effect in business activities, including the aspects of financial investment, marketing and business negotiation. Based on the analysis, it turns out that the anchoring effect plays an important role in business activities. It is so ubiquitous that many people fail to even notice it. In essence, anchoring taps into cognitive biases, allowing businesses to steer decisions, maximize profits, and create compelling narratives around their products or services. Ignoring this effect risks losing strategic advantages or making incorrect decisions in competitive markets.

Keywords: Anchoring effect, financial investment, marketing, business negotiation

1. Introduction

The author felt deeply interested in the anchoring effect when she observed that people tended to buy a product with a price tag that was much lower than the original price even though they didn't actually need it. The anchoring effect is a type of cognitive bias that causes people to favor information they have received early in the decision-making process. People hold on to this information and view it as a reference point, ultimately failing to adjust their initial impressions. From a cognitive psychology perspective, the anchoring effect can be attributed to heuristic thinking. Findings from multiple fields have shown the powerful effects of anchoring. This paper seeks to evaluate the anchoring effect in business activities. First, the anchoring effect influences people's behaviors in the investment process. Then, the anchoring effect can be used in marketing, including pricing and promotional activities. Finally, in business negotiation, the anchoring effect also plays an important role. This paper can effectively help consumers and investors procure a deeper understanding of the anchoring effect, avoid the interference of information and behave more efficiently in decision-making.

2. The Anchoring Effect

2.1. Definition of Anchoring Effect

The anchoring effect, a common concept in behavioral economics, refers to a phenomenon that people tend to rely too much on the first piece of information they receive. People perceive it as the reference point (anchor) to make following judgments. The concept of anchoring in decision-making originated

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with Slovic, who investigated descriptions of preference reversals [1]. However, the primary focus of the present study will be on the anchoring-and-adjustment heuristic, initially proposed by Tversky and Kahneman in their groundbreaking work on judgment under uncertainty. According to Tversky and Kahneman, the anchoring effect is the disproportionate influence on decision-makers to make judgments that are biased toward an initially presented value [2]. This heuristic approach suggests that anchoring bias arises due to inadequate adjustment, as final judgments tend to converge towards the initial point of consideration in the judgment process. After that, many studies have indicated the prevalence of the anchoring effect in human decision-making processes. For instance, Thorsteinson et al. did both laboratory and field studies to explore the influence of uncorrelated anchor points on performance judgement [3].

2.2. Psychological Mechanism behind Anchoring Effect

From a cognitive psychology perspective, the anchoring effect can be explained by heuristic thinking, that being a quick and efficient way of processing information that does not always lead to accurate results. When an individual first encounters a piece of information, their brain unconsciously uses it as a reference point, affecting subsequent judgments and evaluations related to it. Heuristics can be thought of as general cognitive frameworks humans rely on regularly to reach a solution quickly [4]. Heuristics usually occur when one of five conditions is met: When one is faced with too much information; when the time to make a decision is limited; when the decision to be made is unimportant; when there is access to very little information to use in making the decision; or when an appropriate heuristic happens to come to mind at the same moment [5]. The widespread use of heuristic thinking in human society underscores the importance of assessing potential weaknesses. Particularly, while heuristics facilitate rapid decision-making, they also predispose us to various cognitive biases, which refer to prevalent but incorrect judgments that stem from irrational cognitive patterns. To put it simply, it occurs when a subjective perception is mistakenly perceived as a reliable and objective truth.

3. Applications in Business Activities

Due to the insufficient adjustments, people may form wrong or irrational decisions in various situations, such as financial investment, business negotiations and marketing.

3.1. Financial Investments

The anchoring effect can cause investors to make incorrect financial decisions, such as buying an overvalued investment or selling an undervalued investment. Historical benchmarks, such as acquisition prices, often influence market participants' decisions, causing them to deviate from rational choices based on current market pricing. In the realm of investing, anchoring bias manifests in various ways. One example is traders being psychologically tethered to the purchase price of a security. Specifically, if a trader bought stock ABC at $100, they tend to use this price as a reference point when deciding to sell or buy more, neglecting ABC's actual value based on fundamental analysis. There is also a laboratory experiment done by Sascha Baghestanian and Todd B. Walker in 2015 showing that there is a relationship between anchoring and bubbles [6]. The results indicated that establishing a visual anchor at the fundamental value (FV) in the initial perio can eliminate or substantially diminish bubbles. In the absence of an FV-anchor, bubble-crash patterns arise.

The manifestation of anchoring bias is evident in the stock price forecasting endeavors of analysts, who employ the initial stock price as a reference point. Investors' expectations can be influenced by analysts' earnings forecasts and target prices. A higher target price set by an analyst may lead investors to retain their stock holdings longer, anticipating it to meet that value. However, these forecasts are not always accurate, and utilizing them as a reference point can breed overconfidence and lead to

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flawed decision-making [7]. For instance, analysts may anchor to an index's current value during a bull market, predicting future values close to this level without considering the index's historical variability indicated by its standard deviation. Therefore, the anchoring effect has a great impact on the investment process.

3.2. Marketing

The anchoring effect can be used in marketing, including pricing and promotional activities.

Pricing plays a crucial part when consumers consider whether to buy the products or not. Since marketers have a good command of the anchoring effect, they always offer reference prices in order to affect perceptions of consumers and attract them to purchase. For example, in 2010, Steve Jobs, the founder of Apple, used this method by offering a reference price of $999 for the first iPad when it was introduced, but reduced the price to $499 shortly thereafter. Therefore, more people were influenced to purchase the product at $499 solely believing that it was cheaper than the initial $999 price, while ignoring and not making any sufficient and correct adjustments. In this case, by keeping consumers' speculation about higher prices anchored in their minds, Apple succeeded in making the actual price of the iPad seem like a good deal [8]. Hence, merchants can set anchors in the minds of consumers to let them subconsciously make incorrect or lazy judgments about the true price of the product, attracting more consumers to purchase, thus allowing merchants to reap more benefits.

Apart from pricing, the anchoring effect can be applied in promotional activities. Consumers are attracted by promotions because they think the price after discount is more reasonable. One of the most common examples in shopping is a flash sale. A flash sale means that the promotion is offered for a certain limited time, which can develop a sense of urgency among consumers. The well-known flash sale events are Black Friday and Cyber Monday. Shoppers in the United States spent $9.8 billion on Black Friday and $12.4 billion on Cyber Monday in 2024 [9]. However, flash sales aren't just limited to these two. For example, Abercrombie & Fitch offered a discount of 25% off cold-weather classics for a 48 hour period from November 1, 2024, which was sure to make consumers excited and successfully enticed them to buy. Therefore, by setting a low price anchor point and a limited promotion time period, consumers' desires to purchase is stimulated because they believe that they will save money if they buy the goods during the sales promotion period and want to avoid regret in the future of missing such a deal, even though they possibly do not actually need it desperately.

3.3. Business Negotiations

Research has indicated that irrelevant of whether analyzing buyers or sellers, those who made the first offer gained a better outcome. What's more, the final prices have been found to be positively correlated with first offers [10]. The cause of this positive correlation is the anchoring effect and adjustment heuristic, suggesting that the individual makes an estimate from a starting point, which is also called the anchor point, without adjusting it sufficiently. By this way, when sellers offer a high price initially, buyers will focus on this high price and ignore their own expectations, ultimately resulting in a high final price. In addition, even certain given anchors are implausible, people may also be affected by the anchors. For example, when subjects were asked to estimate Gandhi's age at death, they were biased by the anchors of 9 and 140 years [11]. In this experiment, the participants were composed of 60 German university students of both genders. They were presented with two inquiries. Half of the participants were queried about whether Mahatma Gandhi was older or younger than 9 years old at the time of his death, serving as the low anchor condition. The remaining half were asked if he was older or younger than 140 years old when he died, functioning as the high anchor condition. Subsequently, all participants were requested to estimate Gandhi's age at the time of his death. The results revealed that those in the high anchor condition guessed, on average, that Gandhi was 67 years old when he died, whereas those in the low anchor condition estimated his age at death to be 50 years old. In conclusion, this study underscores the anchoring effect, illustrating how numerical information presented prior to making a judgment can significantly influence subsequent assessments, even when the figures presented are unrealistic. This has important implications for understanding how prior information can skew perceptions and decision-making processes. Therefore, in the business negotiation, the side receiving the first offer will often use the value of that offer as a yardstick.

The anchoring effect also works in crafting a bolstering range, which includes the single-digit offer at one end and a higher number at the other end, such as a seller asking $500-550 instead of $500 for a product. The results of the experiments done by Ames and Masons showed that consumers who accepted bolstering range offers made greater concessions because they thought sellers might have a higher bottom line [12]. By setting a bolstering range, negotiators leave themselves plenty of room for price cuts and concessions in subsequent negotiations. This helps to satisfy the other side's desire to bargain, which also allows negotiators to be more flexible in various negotiation situations. In addition, when comparing to those who accepted the single-figure offer, these others were more concerned about any perceived impoliteness if they made a counteroffer outside of the range [13]. As a result, they were more inclined to counter within the range that the buyers had offered.

4. Conclusion

This paper discusses the definition, psycological mechanism and especially the applications in business activities of the anchoring effect through case studies. Consequently, a conclusion is drawn that the anchoring effect can be present anywhere within business activities, from financial investment, and marketing to business negotiation, resulting in people making insufficient adjustments. The anchoring effect, which is a well-established concept within the realm of behavioral economics, pertains to the propensity of individuals to unduly rely on the initial piece of information encountered in the decision-making process. It can be attributed to heuristic processing, which is a mental shortcut for quickly and efficiently handling information, albeit not always yielding precise outcomes. It plays an important role in business activities. To be more specific, the anchoring effect can be used in people’s behavior in the investment process, pricing and promotional activities. Also, due to the anchoring effect, the final prices have been found to be positively correlated with the first offers. This essay provides guidance to allow consumers to act more rationally and wisely in the decision-making process. Although the anchoring effect often leads to bias, strategic use of anchors can enhance marketing efficiency and negotiation outcomes. The methods of mitigating the bias caused by the anchoring effect include raising awareness and collecting multi-source information. However, there are still some limitations in this essay. For example, many other fields that are applied to the anchoring effect are not discussed, such as judicial and legal systems, healthcare and medical diagnosis and education and performance evaluation. More relevant research still needs to be done in the future, thus helping more people avoid the biases when making decisions.

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