Trader Bias: Anchoring

By Paul Doggett

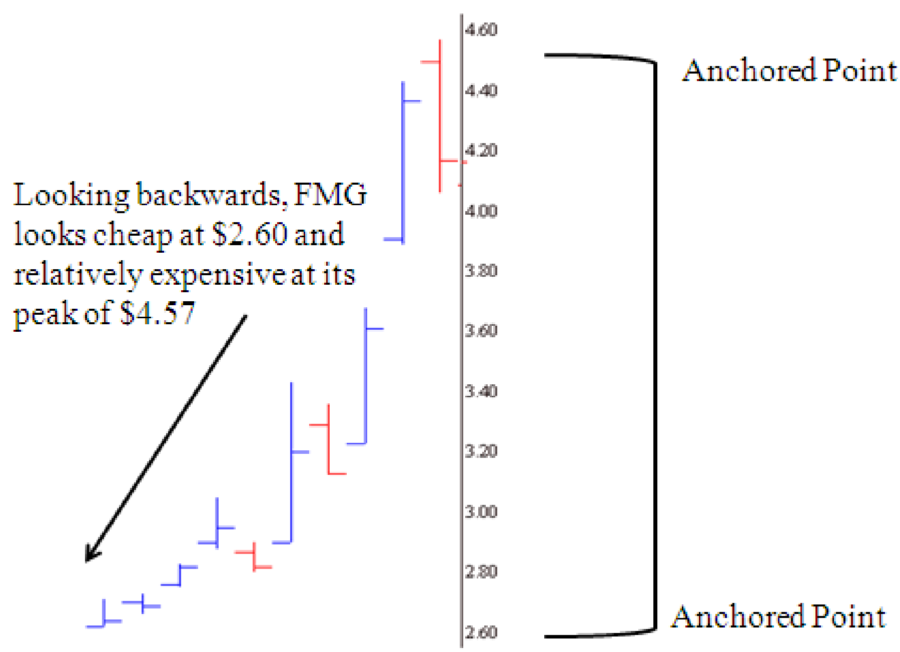
There is a famous Zen story about two travelling monks who come across a beautiful, well dressed young lady stranded on one side of a shallow river crossing. The older of the two monks picks up the woman and carries her across the river. Upon seeing this, the younger monk becomes annoyed, but remains silent until they arrive back at the monastery at which point he loses his temper and says to the older monk, “How could you consider carrying that woman in your arms like that? It is against our teachings. It is tempting temptation itself!” The older monk calmly replies, “I put her down at the roadside. It seems that it is you who is still carrying her.”

This story demonstrates anchoring. Anchoring is the psychological phenomenon where we cling onto a particular episode in our memory and use it as a reference point when making decisions and taking action in the future. Anchoring is one of the most applicable psychological phenomena in the markets and can help to explain our buy, hold and sell decisions.

Individual traders typically become anchored at the price at which they buy and sell stocks. That price becomes a reference point which is use to gauge whether the stock they brought is currently cheap or expensive. For example, in June 2009 FMG was trading around $2.60. Let’s assume that you thought it was cheap. A fortnight later it reached $4.50. This is a 57% increase.

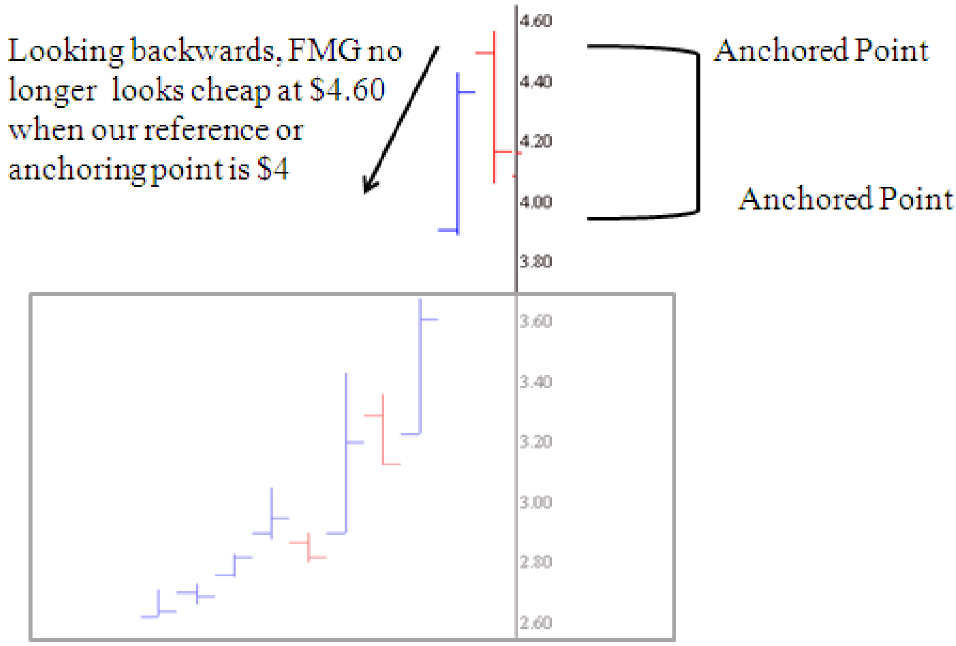
At $4.50 is FMG still cheap or is it now expensive? I know most people would say that this is a rhetorical question – it’s a no brainer, right? If the FMG share price has gone up 57%, then of course it is now more expensive (Fig. 1a).

Fig. 1a. FMG



However everything is relative. FMG is perceived to be expensive because we are comparing the $4.57 share price to the $2.60 share price. We are in effect anchored at the $2.60 share price. If I asked the same question and said that FMG was trading at $4 then a week later it was trading at $4.57 (Fig. 1b.), would you now consider FMG to be cheap or expensive, what would you say?

Fig. 1b. FMG



I would suggest that most people's opinion about FMG's value now changes from the first example because they are now anchored to comparing FMG's value between $4 and $4.57.

What anchoring does is commits us to short term, easy to figure out comparisons. When I've put the FMG exercise forward in a group setting, no one ever stops to consider if FMG is still cheap at $4.57 on a growth basis going forward. Everyone, without exception, always considers FMG expensive within the short term historical context that I frame for them by telling them that FMG was $2.60 and then two weeks later it was $4.57.

Understanding anchoring offers us a meaningful way to better understand ourselves and the thoughts of other market participants. One of these meaningful ways is to apply our knowledge of anchoring in a broader market setting. For example, we can enter a position in a stock near a support level and know that there is a reasonable probability of that support level holding because many others are already in anchored at that point and are loathed to sell below that level.

How do we know this? We know this because the chart (Fig. 2) shows us that buyers have routinely come in for a stock at or near a certain price level (therefore creating price support). The longer this stock moves in a sideways trend channel, the longer the time frame that the market has had to manufacture its anchored positions on what constitutes relative value (cheap or good value at X, and over priced at X).

Fig. 2

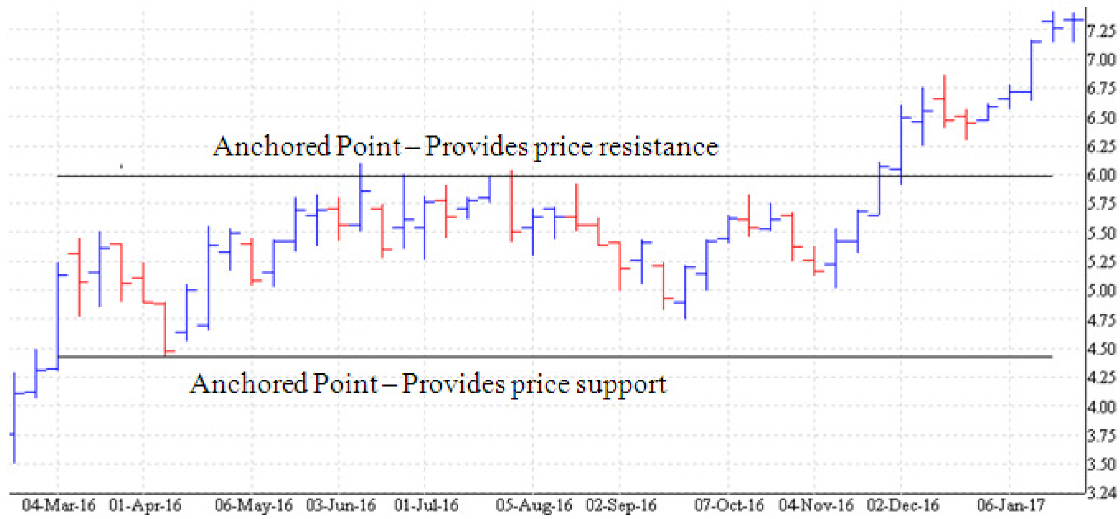
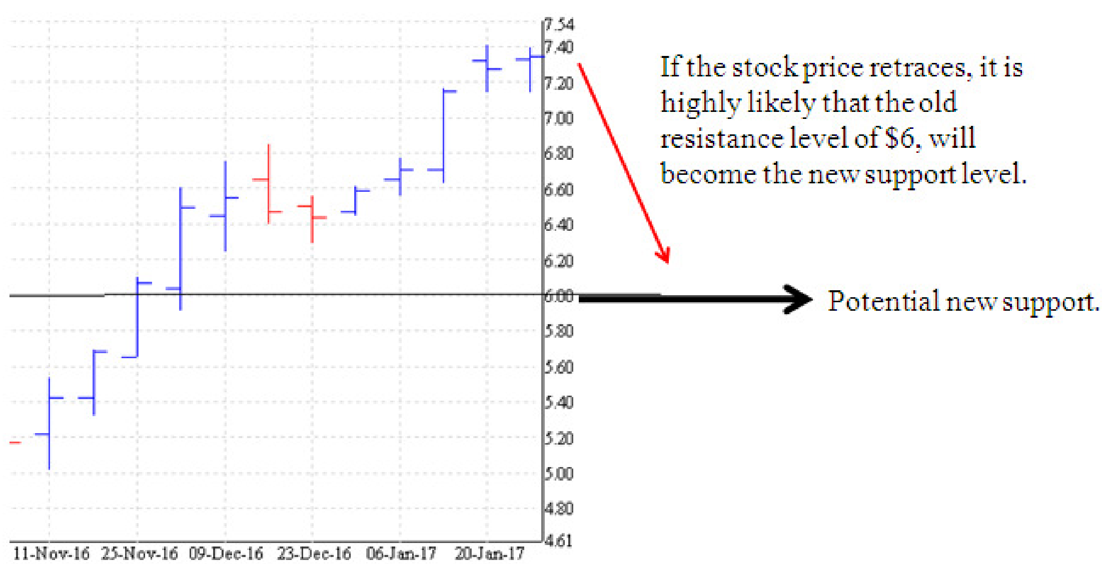


Fig. 2 also provides a deeper understanding as to why resistance levels is also often formed in fairly straight lines across a chart, encompassing a certain close knit range of prices. It is these levels that price anchoring occurs and many in the market feel that at these levels, the stock is either fully valued or has limited to no further upside potential and so we see holders of the stock selling out and we see new buyers unwilling to pay more than the price which has become a resistance level.

Those who buy the stock in and around $6.00 (resistance) will become anchored to their buy price so that IF and WHEN the stock breaks beyond resistance, they will see their purchase price as a good buy and they will be unwilling to sell the stock below this price. Therefore in this way we can explain how it is that resistance often becomes support.

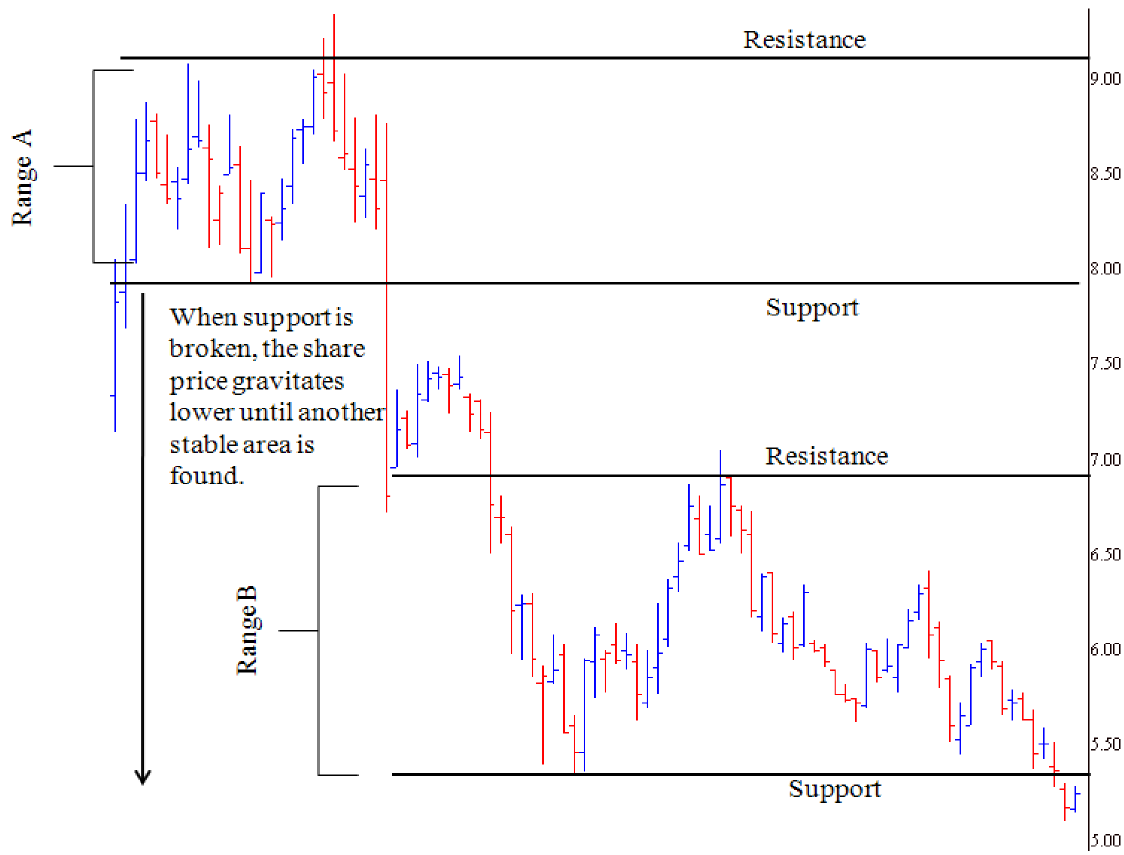
Fig. 3



Looking at Fig. 3 we can say that if the stock price retraces, it is highly likely that the old resistance level of $6, will become the new support level. Why? Because those who bought the stock close to the $6 level during its sideways movement and those who bought it on the breakout above $6, are anchored to this price. For them the stock is cheap and / or, this particular price marks where they begin to make a loss, therefore they will resist selling below this level and thereby create new support.

If support is broken however, we know to stand aside because the share price will generally fall until it finds another, lower anchoring point. We see this occurring in Fig. 4, when support is broken in Range A, the share price eventually finds support again at the bottom of Range B.

Fig. 4



Most of us can probably recall a time when we experienced this phenomenon of anchoring in the market, either with an individual share price or with an index level. It is irrational for us to become anchored by past prices because the market is always changing. Breakouts often offer opportunity. But in order to take up the opportunity, we have to leave behind any thoughts that a stock price, which is moving higher as part of the breakout, is now expensive. When we remain anchored at the pre-breakout price, we potentially curb any desire to enter the trade on the breakout. We have all missed out on a trade because we refused to move our bid higher than where we first placed it in the market due to being anchored at a certain price level in the belief that this price level offered a good entry point and that anything higher was too expensive. From this point of view anchoring can be a wealth hazard if not understood and kept in check.

The advantage for us as informed, private traders is to understand that anchoring does occur in the market and we can use it to our advantage and recognize when support and resistance are halting the decline or advance of stocks and we can recognize when a strong mental anchor or price level in the market has been breached and we can act accordingly.