



ANCHORS A-WEIGH

Bias in real estate pricing and valuation

BY MICHELE WOOD

In the field of psychology and its recent hybrid offshoot, behavioral economics, researchers have identified common heuristics (mental shortcuts) that we use to make decisions in our everyday lives. While enormously helpful in everyday situations, these heuristics often lead to unseen biases in our decision-making. One such bias is called “anchoring.”

The anchoring bias was first identified by Daniel Kahneman and Amos Tversky in their article *Judgment Under Uncertainty: Heuristics and Biases*, which appeared in the journal *Science* in 1974. They claimed that people make estimates by starting from an initial value that is adjusted to yield the final answer. This is a perfectly reasonable way for estimations to be made of course, but their experiments revealed that people were often starting from (anchoring) to the wrong values or failing to account for differences between their anchor number and their estimate. The researchers showed that “different starting points yield different estimates, which are biased toward the initial values.” In other words, people “anchor” to a value in their experience and rely too heavily on this in their estimation of a new value.

In one experiment, subjects were asked to estimate the number of African countries in the United Nations. They expressed this estimate while watching a wheel of fortune spin. Unbeknownst

to the subjects, it was rigged to land on only two different numbers. The subjects were then asked if the percentage of African countries in the UN was higher or lower than their wheel number, and by how much. The results were dramatic. For the subjects who saw a “10” on the wheel, the median estimate for the countries was 25. For those who saw a “65” come up on their spin, the median number was 45. Subsequent experiments done by numerous other researchers using different prompts have yielded the same conclusions and the effect is now well-established. What’s truly surprising is that the anchor might be obviously unrelated to the question.

Effects on Appraisers and Brokers

In 1987, Gregory Northcraft and Margaret Neale at the University of Arizona showed a marked anchoring bias in valuation of real estate. The researchers carried out two identical experiments—one on a group of students and the other on a group of real estate agents. The teams were given a single-family home to appraise, were sent to the site to inspect the home and were given information packets that included the subject’s list price, the MLS sheet for the subject, a summary of sales and other industry-typical data. The subjects were then asked to estimate the following:

- 1) The appraised value of the property.
- 2) An appropriate listing price.
- 3) A reasonable price to pay for the house.
- 4) The lowest offer they would accept for the house if they were the seller.

The information packets were identical with the exception of the subject property’s listing price, which was set by the researchers to one of four separate values. All of the test subjects’ value estimates showed significant evidence of anchoring in the results, as seen in one summary chart below:

Results for Experiment 2: Mean Estimates of Expert Subjects

Pre-Set Listing Price	Appraisal Value	Listing Price	Purchase Price	Lowest Offer
\$119,900	\$114,204	\$117,745	\$111,454	\$111,136
\$129,900	\$126,772	\$127,836	\$123,209	\$122,254
\$139,900	\$125,041	\$128,530	\$124,653	\$121,884
\$149,900	\$128,754	\$130,981	\$127,318	\$123,818

Based on the agents’ responses, the chart shows a significant variance in appraised value of \$14,550 or 12 percent. These subjects were experienced real estate agents who had been practicing for several years in the field. Because the only difference in the information was the listing price, the only possible explanation for the variance is the information about the list price. Moreover, when polled about their decision-making processes, very few agents identified the listing price as an important consideration in their deliberations.

Similar results have been found using professional appraisers as subjects. The subject’s list price serves as an anchor to the value of the property and is frequently not adjusted adequately to account for the bias. Given the potential for the subject listing to improperly influence opinion, it is interesting to consider the utility of the requirement under USPAP to analyze the current subject listing.

Effects on Property Buyers and Negotiators

Buyers may also be subject to anchoring on numbers that are not relevant. As shown above, if a list price is too high, it can influence the offers, the appraisal and the final sale price, leading a buyer to end up paying too much for a property. In typical market transactions, a potential buyer’s agent may have a tough time convincing their client that a price is irrational if the buyer has anchored onto an inappropriate number. More likely is the challenge facing a buyer or a buyer’s agent if the seller has anchored on a bad number. Sellers are very susceptible to anchoring on non-market indicators such as previous price paid, a bad appraisal, or a nearby property they perceive as comparable but in fact is not a good comparison.

The “loss aversion” phenomenon plays a large role in inducing anchoring behavior. This is a concept whose key idea is that people react differently to losses than to gains. More specifically, losses are shown to be felt twice as powerfully as equivalent gains. For example, it hurts twice as much to lose a \$20 bill than it feels good to



unexpectedly find one. If an owner paid a price for the property years ago and now the market value has decreased, the owner will overprice listings and hold properties much longer than if they are facing a capital gain. A 2010 study by Sheharyar Bokhari and David Geltner found that loss aversion caused significant anchoring biases in pricing behaviors. Surprisingly, the more experienced and larger institutional investors and buyers exhibit at least as much bias as those smaller and less experienced participants. Even experts cannot seem to resist the internal pull to sell winners and hold losers. This can make negotiations between buyers and sellers difficult and often more contentious and lengthy than necessary.

Protection Against the Effects of The Anchoring Bias?

Protecting oneself can be extraordinarily difficult in practice as it is almost always done subconsciously, and most people will deny it even when it is brought to their attention. Furthermore, experts and experienced investors are influenced as much or more than those who are uninformed. For appraisers, the sales comparison approach (which adjusts comparable prices) is an act of anchoring and is the correct industry standard to conclude value. The best an appraiser can do is to be self aware of how a contract or listing price may be improperly influencing their comparable selection and subsequent adjustments. Some corrections can be accurately made through very thorough confirmations and attempts to fully understand the exact circumstances of the buyer's motivations, the seller's history and the nuances of that transaction. It's important to know not just list price, but the days on market and any other offers submitted.

For professionals in right of way work, it may help to understand that a property owner is likely anchoring to a non-market number that the condemning authority is not. For example, is the

property owner facing a loss in the taking? If so, they will hold tighter to that anchor. Has the appraisal come in lower than the price paid for property of a neighbor? If so, the owner may know that number and have anchored to it even if market conditions have changed or the property is not a true comparable. In this case, a more thorough history and explanation of market pricing trends in the property's immediate area can help tell the story of the valuation in a way that an adjustment grid has failed to do.

In Summary

Numerous studies in the last 40 years have identified and proven the existence of what economists call irrational behavior and psychologists call heuristics or biases. The business of real estate is especially fertile for these biases as there are thousands of variables influencing each individual property at a given moment in time, as seen through the motivations and past experiences of two random individuals attempting to conduct a single transaction. It is impossible for real estate professionals to identify and account for each of these variables in each negotiation; but professionals can do a better job of understanding when they or their clients are vulnerable to biases such as anchoring, and work to alleviate the influence that the bias has on valuing the property. ✪



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