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Anchoring Expectations

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BY DAVID A. LAX AND JAMES K. SEBENIUS
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After 10 years in business, Carl, a successful entrepreneur, decided to put his software-services consulting firm up for sale. Carl was unsure how much a buyer would be willing to pay for his company. He hoped for an offer of at least $40 million, but decided before entering negotiations that he’d settle for as little as $20 million.

OmniData, a company in a related software-services sector, quickly emerged as a potential buyer. Carl was quite uncertain about the maximum OmniData would be willing to pay. Thus, while Carl knew that the zone of possible agreement (ZOPA)—the set of outcomes that both he and OmniData would prefer to no agreement—was bound at the lower end by $20 million, he didn’t know about its upper end. OmniData engaged an investment bank with significant industry expertise as its representative in the sales negotiations with Carl and his team. The head banker opened talks by stating, “We’ve made 19 acquisitions of software-services firms this year for OmniData and have paid no more than 10 to 12 times earnings, less a private company discount.” This implied a selling price of $15 million to $18 million, well below Carl’s walkaway price. The banker then presented a seemingly thorough analysis of comparable industry transactions that specifically compared price/earnings (P/E) multiples and again showed a range of 10 to 12 times earnings.

Carl’s uncertainty about prospective bids led him to be taken off-guard by the banker’s implied $15 million to $18 million anchor. He felt disappointed. His perception of what was possible in the negotiation had shifted; now he sensed that the most he could get was $25 million. His perception of the ZOPA had been anchored by the investment banker’s presentation. How does this anchoring occur?

Cognitive psychologists have found that people systematically assess uncertain quantities in unconsciously biased ways. In particular, we tend to irrationally fixate on the first number put forth in a negotiation—the anchor—no matter how arbitrary it may be. Even when we know the anchor has limited relevance, we fail to sufficiently adjust our judgments away from it.

Uncertainty is fundamental to the negotiation process. A clearer understanding of how you and others manage the unknown can keep you from making costly mistakes as a result of anchoring. Anchoring can be used defensively, to prevent your assessment of the ZOPA from being influenced by extraneous information, and offensively, to shape your counterpart’s perceptions of the...
**Anchoring Expectations (continued)**

ZOPA and achieve negotiated outcomes you find more attractive.

**Anchoring and its influence on negotiators**

Numerous studies—many offering real monetary stakes to the subjects for supplying correct answers—have shown that extraneous information can profoundly influence our judgments in the face of uncertainty. In one of our experiments, we presented senior executives with a situation in which a supplier gets a one-time rush order for high-tech motorcycle headlamps from a Japanese manufacturer. The executives, taking on the role of the supplier, are asked to make the manufacturer a price offer.

All of the executives receive identical sales scenarios (product, company, industry, financial, and production data), and all are told that the Japanese translator has been very difficult to understand and has made numerous mistakes during the negotiation. Half of the executives are told that the translator appeared to ask for an offer in the $12 per unit range, but that when asked to clarify, he denied specifying any particular price. The other executives are told that the translator seemed to ask for an offer in the $32 per unit range, but that when asked to clarify, he denied mentioning any price at all. In both scenarios, as they prepare to make an offer, the executives are instructed to regard the $12 or $32 suggestion as genuinely meaningless due to the translation problems.

The average offer among executives who heard the meaningless $12 offer was $19.80 per unit. The average offer among those who heard the meaningless $32 offer was $30.10. The irrelevant numbers $12 and $32 served as anchors, pulling offers in their direction.

Furthermore, we’ve found that our negotiators were typically unaware of the large effect of the meaningless offer on their price proposal. The sidebar “The Power of Random Numbers” on this page gives another example of how irrelevant data affects our decisions.

Even negotiators with deep industry knowledge find their assessments anchored by irrelevant data. Studies of real estate agents and German car mechanics show strong anchoring effects when they are asked to make valuations of houses and cars, respectively. Similarly, when we asked general managers of a sports league to estimate a player’s salary increase, their estimates were anchored by the comments of a clearly unknowledgeable sports-radio fan.

How does anchoring influence negotiated outcomes? When you enter a negotiation, you typically don’t know how the other side values its BATNA, or best alternative to a negotiated agreement, and she is typically ignorant about your walkaway point as well. As a consequence, both sides are uncertain about the ZOPA. When an anchor is introduced into the negotiation, it can shift perceptions of the ZOPA in its direction, thereby increasing the odds that any final agreement will drift toward the anchor. The result? A final agreement that’s favorable to whomever “dropped” the first anchor.

**THE POWER OF RANDOM NUMBERS**

In their first experiment on anchoring, Daniel Kahneman and Amos Tversky spun a wheel marked with integers ranging from 0 to 100. Participants were asked whether they thought that the percentage of U.N. member countries that were from Africa was greater than or less than the number just spun on the wheel. They then were asked for their best estimate of the proportion in question.

For one group of the subjects, the wheel stopped at 10. The vast number of these subjects said that the proportion of U.N. member countries that were from Africa was more than 10%; on average, they guessed that the actual percentage was 25%.

For another group of the subjects, the wheel stopped at 65. Almost all of these participants said that the proportion of the U.N. member countries that were from Africa was less than 65%. In contrast to the first group, this group’s average guess was that 45% of U.N. member countries were from Africa.

The only difference between the two experimental conditions was the number on the wheel, yet the groups’ best estimates differed by 20 percentage points! The number the subjects were given dramatically—and irrationally—anchored their assessments.

Defending yourself against anchors

There’s no cure-all to prevent yourself from being anchored, though becoming aware of the risk and reducing uncertainty through preparation can help. In addition, anchoring first makes it harder for the other side to anchor you.

When the other side introduces an anchor, what should you do? You might try to diminish an anchor’s impact by changing the metric under discussion. Returning to our opening story, Carl found himself anchored at a selling P/E multiple of 10 to 12, which implied a sale price between $15 and $18 million. At this point, he hired experts to negotiate the valuation issue on his behalf. The consultants accurately presented themselves as financially sophisticated yet lacking deep knowledge of the software-services field. Looking at the P/E multiples of comparable transactions, as the investment bank had done, would only drive the unfavorable anchor in even
deeper, the consultants believed. Instead, they prepared a discounted cash-flow analysis to value Carl’s company, using some fairly aggressive assumptions; this led to a valuation as a standalone company that was roughly double what OmniData had proposed.

As they presented the valuation to OmniData and its investment banker, the consultants explained that, due to their limited industry expertise, they were open to persuasion about some of the assumptions in their analysis. Soon the other side was anchored in the new metric of a standalone company valuation, analyzing the assumptions that went into the discounted cash-flow analysis. The two parties began negotiating down from a high price rather than up from a low one. The transaction closed at a much higher P/E multiple than any other in the industry in the previous two years—but very much in line with a more modest version of the original “counter-analysis.”

By changing the metric from P/E multiples to standalone company valuation, the consultants “unfroze” the previously established anchor and established a new one.

**Using anchors offensively**

There are a number of ways in which you can use anchors to your advantage in negotiation. In our July issue, Adam D. Galinsky argued in his article “Should You Make the First Offer?” that you should try to put an aggressive—but not absurdly aggressive—first offer on the table. Because anchors are especially influential under conditions of uncertainty, the first offer has a much bigger anchoring effect than subsequent ones. In addition, because anchors shift negotiators’ perceptions of the bargaining range, more aggressive offers tend to be more influential than less aggressive ones.

We agree that it is desirable to anchor first in many negotiations, for several reasons. In negotiation, you are trying to both learn about the ZOPA and influence the other side’s perception of the ZOPA. While advance research can help you reduce your uncertainty about the ZOPA, you typically will have more to learn about the ZOPA once talks begin. As such, you will be vulnerable to being anchored. Therefore, anchoring first in price-oriented negotiations can be both good offense and good defense.

An overly aggressive offer, however, risks derailing negotiations if it causes the other side to question your credibility or to wonder whether agreement is even possible. Because it is hard to know what your counterpart will view as absurd, anchoring with a relatively inflexible, extreme offer increases the probability of reaching a stalemate. Anchoring instead with a flexible but extreme offer gives you a lower-risk opportunity to favorably shape your counterpart’s perceptions of the ZOPA. Carl’s consultants, for example, prefaced their aggressive offer by assuring OmniData that they were open to persuasion about their assumptions, thereby making their offer more flexible.

The most effective anchors further reduce risk because, rather than placing firm offers on the table, they merely introduce relevant numbers. A job applicant may state his belief that people with his qualifications tend to be paid between $85,000 and $95,000 annually, or he might mention that a former colleague just received an offer of $92,000. Similarly, someone hoping to sell her company might make a confident assertion to a potential buyer: “A business broker advised us that we can sell for 25 times earnings.” These assertions are not offers; they’re anchors that affect the other side’s perceptions of the ZOPA.

Finally, you can also anchor by citing apparently comparable agreements as precedent. Consider the case of a money manager preparing to negotiate her annual bonus. “While bonuses last year were 50% of salary,” she might tell her boss, “I recognize that this year will not be as good as last year.” Another approach is to mention proposals made by more extreme elements of one’s constituency. A prospective customer might tell a salesperson that, while he loves the product, his purchasing department is undoubtedly going to demand price cuts of 15% or more. Such statements can have an anchoring effect without requiring you to make an extreme offer that could jeopardize talks.

In our studies, we’ve observed that many negotiators successfully anchor talks by focusing not on a price or financial terms, but on a conception of the nature of the problem the negotiation is meant to resolve. We call such moves to define the problem meta-anchoring because they shape parties’ expectations of the ZOPA at a higher level of abstraction than any single number could. In our next article, we will take a closer look at meta-anchoring and show you how to use it effectively in your negotiations.

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**David A. Lax**, formerly a member of the Harvard Business School faculty, is a principal of Lax Sebenius LLC. **James K. Sebenius** is the Gordon Donaldson Professor at Harvard Business School and a member of the Executive Committee at Harvard Law School. They are co-authors of 3-D Negotiation: Creating and Claiming Value for the Long Term (Harvard Business School Press, forthcoming). They can be reached at negotiation@hbsp.harvard.edu.

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