Financially Speaking

Our View of Price is Impacted by Psychology

Like many of you reading this I drive past a billboard every day on my way to the office that has been telling me for most of the year that things are expensive. It's not a sign that a political candidate pays for or that someone painted on plywood and stuck in their yard, though those certainly exist too. No, the billboard that I see every day is the sign at Kwik Trip telling me what gas prices are.

Just like there is a saying that all politics are local, I would make the case that most economic conversations in the US start with gas prices. We are a mobile society that enjoys the freedom to travel, often in our private vehicles, so the price of gas is something that we tend to pay attention to. For several months this year I had nearly daily conversations with people about gas prices and how much they had gone up.

It is totally understandable why gas prices were such a major topic of conversation – we almost all use it, the price is literally on big signs everywhere we go, and, with only a few exceptions, the price in the United States has been relatively stable for many years.

What I found fascinating though was the comparison that people would draw when thinking about how much the price had changed.

They didn't compare to what gas prices were before Russia invaded Ukraine, or what they were last summer when Covid vaccines first became widely available, or frankly to just about any month since 2005 when the average price for a gallon of regular in the Midwest has fluctuated somewhere between $2 - $4 a gallon, according to the US Energy Information Administration. Instead, many people compared current gas prices to the brief dip that occurred in April of 2020, when demand for gas fell dramatically because people suddenly stayed home due to the advent of Covid, and the average price for the month dipped to $1.54 a gallon.

Because so many people have pegged that Spring 2020 price as their comparison, they may always feel like gas prices are too high, even though prices today are back within the historic 15-year normal range.

This concept of picking the lowest price in memory to compare to is so common that the people who study the psychology of how people think about money – called behavioral finance – have even given it a name. It's called Anchoring.

When people Anchor their perceptions can become clouded by comparisons to one, sometimes arbitrary, price point. Gas prices are one example of this that we likely can all relate to, but the same concept can apply in the opposite direction as well.

Let's use a hypothetical example to illustrate this point.

Let's say that you invest $1000 in a stock in 2015. Over time that stock's price fluctuates but when you receive your statement at the end of 2021 it is worth $2000. You continue to hold onto the stock and when you receive your June 2022 statement you see that the value has dipped to $1800.

Behavioral finance tells us that the instinct of most people is going to be to open that most recent statement and feel like they lost $200 because they have Anchored their view of what the stock should be worth to the highest price that it ever achieved - $2000. I would suggest however that they reframe their perspective by thinking about it in terms of how they would describe that investment to someone else. If that was your stock, would you say that owning it had resulted in you losing $200 or gaining $800?

As you can see, sometimes the way we view prices is clouded by the perspective that we view them through. Before making a judgement about the price or value of something first make sure that you are framing any comparisons in a reasonable way – and not just Anchoring to the highest or lowest point.

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