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A homeowner's dilemma: Anchoring in residential real estate transactions

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ABSTRACT

We examine whether, and how, listing strategies impact sale prices in residential home sales. Literatures in housing economics, negotiations, and auctions offer diverse predictions around this question. On the one hand, housing studies typically treat home prices as an objective function of property and neighborhood characteristics. Yet, the large and robust literature on anchoring effects (Tversky and Kahneman, 1974) suggests a positive relationship between listing prices and sale prices. Finally, evidence from the auctions literature suggests the opposite pattern through herding behaviors. We analyzed more than 14,000 transactions, taking into account observable property heterogeneity, geographical location and timing of the sales. We find that higher starting prices are indeed associated with higher selling prices, consistent with anchoring. For the average home in our sample, over-pricing between 10 and 20% leads to an increase in the sale price of $117–$163. This effect is particularly strong in areas with higher rates of mortgage foreclosure or serious delinquency. Additional analyses show that our results are unlikely to be driven by seller motivations or unobserved home qualities. We contrast our findings with recommendations and private beliefs of real estate agents, who provide services and advice for about 90% of home sales in the US.

1. Introduction

For the vast majority of homeowners, the home is the dominant asset in their portfolio. For younger home-owning households, the house value can be several times the value of the household's net wealth (Flavin and Yamashita, 2002). Thus the sale of a home is likely to be the most significant financial transaction of the owners' lifetimes, and one that a typical home-owning household faces repeatedly: over a two-year period, 12% home-owning households in the US move (Ferreira et al., 2008, based on 1985–2005 AHS data). Among the many stressful decisions that go into a home sale, perhaps the most agonizing one involves the setting of the initial "listing price." Yet, despite the importance and frequency of home sales, the research literature is yet to offer a clear recommendation as to the basic strategy sellers should pursue. In the present research we explore this issue from the vantage points of three different literatures, analyze a large and diverse data set of market transactions, and contrast our findings with realtors' recommendations as well as their private beliefs.

Research on anchoring and insufficient adjustment (Tversky and Kahneman, 1974) has repeatedly demonstrated that exposure to even irrelevant numbers makes individuals' subsequent quantitative judgments assimilate to the "anchor." Anchoring affects the price that consumers are willing to pay for goods and experiences (Ariely et al., 2003; Green et al., 1998; Northcraft and Neale, 1987; Simonson and Drolet, 2004) and the outcomes of distributive negotiations (Galinsky et al.,

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2002, 2005; Galinsky and Mussweiler, 2001). The available evidence for anchoring effects suggests that home sellers would benefit from setting higher listing prices.

This conclusion, however, is in direct contrast with most of the economic literature that considers housing prices to be rational, and ultimately determined by characteristics such as location and amenities (Sheppard, 1999). From this perspective, market forces are expected to correct any strategic pricing behaviors. Laboratory results demonstrating a relationship between opening prices and selling prices are generally dismissed as the product of experimental demand in absence of real market conditions. Conversely, demonstrations of anchoring-like effects using market data are often critiqued for failing to sufficiently control for potential confounds.

A third literature, one dealing with auction behavior (Gneezy, 2005; Gneezy and Smorodinsky, 2006) offers yet another set of predictions. A typical home sale begins with an auction-like process, where one or more buyers might submit an offer in response to a listing price. Recent findings show that auctions that open with low asking prices generate a greater number of bids and ultimately finish with higher closing prices (Ku et al., 2005, 2006; Simonsohn and Ariely, 2007). This pattern has been explained through “herding” behavior (Banerjee, 1992) whereby bids by earlier aspiring buyers signal that a particular item is competitively priced and lead others to enter the bidding. Indeed, an analysis of real estate-related web content reveals that professional consensus favors pricing a home low, in the hopes of starting a “bidding war.”

Work by Janiszewski and Uy (2008) recently examined the effect of listing prices in the residential housing market. These authors however, were interested in the effect of *price precision*, and thus chose to eliminate all transactions with multiple offers from their data set, leaving no room for testing herding behavior as an alternative explanation. Thus the question of whether a seller ought to price a good relatively high or relatively low in the context of a consequential information-rich market transaction remains very much unanswered.

In the current paper, we examine the question of initial listing prices in the real estate market using two methods. First, we gather professional advice available to homeowners with access to the internet. We analyzed the content and the tone of the published articles to find out what strategy real estate agents recommend. We further investigate private beliefs of real estate agents by soliciting their recommendations regarding specific, randomly chosen properties in their general geographical area of practice (Study 1). We then compare these recommendations and beliefs to findings based on data concerning all single-family home sales in Delaware, New Jersey and Pennsylvania listed through the Multiple Listing Service (MLS) between January 2005 and April 2009 (Study 2).[1]

While the online recommendations of real estate agents seem to favor underpricing, alluding to a potential herding effect, our market data do not provide any support for this strategy. In fact, underpriced homes systematically fared less well in the data we examined, even in hot markets with frequent transactions. On the other hand, our market data show evidence of an anchoring effect, even after controlling for “fishing” behaviors whereby home sellers wait for a longer period of time in order to receive a higher offer (Bokhari and Geltner, 2011). Private beliefs of agents seemed to be in line with our market findings, and not their public recommendations. When surveyed anonymously, real estate agents predicted that higher listing prices would lead to higher sale prices, even after we account for individual differences, property fixed effects, and listing time expectations.

We go beyond the prior literature in several ways. First we demonstrate the effect of listing strategies on final prices using a large data set of real market data, in the context of a high-stakes, information-rich transaction. Secondly, we utilize several novel empirical approaches to rule out alternative explanations that have plagued such attempts in the past. Finally, by comparing market data to recommendations of professional realtors we demonstrate a likely gap in lay knowledge regarding the most consequential financial transaction of most consumers’ lifetimes.

2. Study 1: Professional pricing advice

In a preliminary investigation of professional consensus regarding over- and under-pricing, we first turned to the same source of knowledge as many home sellers: the internet. We examined the first 100 web pages returned for each of the following Google searches: “home + over-pricing + sell”, “home + under-pricing + sell”, “pricing + strategy + sell + home”, and “pricing + home + for + sale.” 297 of these pages contained professional advice regarding how the initial listing price should be set. Three raters, blind to hypothesis, concluded that of the 94 web pages that discussed under-pricing, 46% recommended it as a sound strategy. Conversely, of the 163 web pages that discussed over-pricing, 96% warned against it.

While this exploratory analysis provides an unambiguous characterization of the advice offered online, one might wonder about the sincerity of such advice. The real estate market is plagued by the standard agency problem since realtors receive only a small portion of the transaction price as commission (Anglin and Arnott, 1991; Geltner et al., 1991; Levitt and Syverson, 2008; Miceli, 1991; Rutherford and Yavas, 2012). Furthermore, internet advice might not be reflective of the private beliefs of realtors. Thus in Study 1 we explored the extent to which realtors privately adhere to the publicly recommended under-pricing strategy by presenting expert participants with specific properties and soliciting their pricing recommendations and expectations regarding transaction outcomes.

[1] It is estimated that around 90% of all homes sales are listed on the MLS. (source: http://www.forsalebyownerhomes.com/mlslisting.html).