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If the price isn't right, why pay it?
By Curtis Seltzer

What is something worth? Is the true value of anything "figureoutable"? Do the prices we pay reflect true value, and, if not, how does that happen?

The basic insight of William Poundstone's, Priceless: The Myth of Fair Value (and How to Take Advantage of It), (Hill and Wang, 2010) is that context-free true values don't exist. The price paid for something -- anything, everything -- is related to its context and is easily manipulated. Each of us, no matter how sophisticated, gets suckered on something, sooner or later.

Poundstone summarizes the findings of psychologists who have researched how human beings assign prices to products and services they're willing to pay. The researchers ask: What explains assignments of price?

They've found that we buyers pay prices in terms of things we know, things we think we know and things we don't know. Hormones influence what we're willing to pay. Photographs. Sex. Dollar signs. Position on a menu. Position in a store. Advertising. Pressure tactics. We -- you and me – can generally be led to a price in excess of true value when the price is presented to us "properly."

Staging residential real estate is a common psychological technique that sellers use to get buyers to pay a higher price than the property is otherwise worth, that is, to get a buyer to pay for nothing. None of the stager's created feel, furnishings, smells, sounds or emotion is a real asset. None of the stager's craft conveys. But the seller's dollar invested in staging reportedly produces higher prices than non-staged property and more than pays for itself, which is why sellers do it.

In real estate, the market "value" of residential property or land is almost always determined through a comparable analysis whereby the dollar worth of the target property is calculated in relation to recent selling prices of three close-by and roughly similar properties. Target-property "value" in a comparable analysis largely means what the three comp buyers were willing to pay for their properties. It's clearly a market value, but it may or may not have much to do with what the target property is worth in any real sense, as measured, say, by replacement cost.

Take a familiar example. A house is fairly and honestly market valued through comparables analysis at $500,000 at the end of 2007, based on the recent sales of three identical houses on the same block. Three years later, this same house is fairly and honestly market valued at $300,000 based on the recent sales of the same three houses. Price in this sense is entirely based on the snapshot expression of current market conditions and context. It has little to do with the cost of building the structure on that parcel of land. It doesn't have much to do with true value.

In both years, the buyer should look beyond fair market value and find something closer to an intrinsic value, a worth of the property to the buyer in light of its assets and liabilities and his resources and plans for it. That should be the buyer's price.

One of the most powerful price-manipulation techniques Poundstone discusses is anchoring.

Let's say you have three identical one-acre lots for sale. You price Lot 1 at $50,000, Lot 2 at $25,000 and Lot 3 at $10,000. You, the seller, believe that the price you would readily accept for each lot is $5,000. But you want more.

The $50,000 Lot 1 price is the anchor that buyers are forced to use for reference in pricing the other two. You don't expect to sell Lot 1 or Lot 2 at the listed prices. Lot 3 appears to be a steal at $10,000. Lot 1 sells, then, for $10,000, which is $5,000 more than you would have accepted otherwise.

That leaves Lot 1 and 2. You cut the price of Lot 1 from $50,000 to $25,000, and advertise the 50 percent discount. You cut the price of Lot 2 from $25,000 to $15,000. Lot 2 sells, then, for $15,000, which is $10,000 more than you would have accepted otherwise.

That leaves Lot 1. Cut its price to $20,000. You have one comparable at $10,000 and one at $15,000. Buyers now know that you're willing to come off your advertised price. Let's say you sell Lot 1 for $12,500. The buyer figures it's a steal, since he got a $50,000 lot for only $12,500 through tactical waiting and shrewd bargaining.

Anchoring has produced a found-money profit of $5,000 on Lot 1, $10,000 on Lot 2 and $7,500 on Lot 3—over and above what you would have otherwise accepted.

And if you're really sneaky, you would price Lot 1 at $50,000 and advertise Lots 2 and 3 as for sale on the basis of "Make me an offer."

One experiment pitted real-estate agents against amateurs in measuring the effect of various anchor prices (listing prices) on offering prices. Anchoring inflated the offers of both groups. Agents, however, were pulled up less than junior and senior undergraduate business students.

The anchor price is the first one on the table. That price frames the buyer's thinking about value. Offers are made in terms of what was asked. Listing prices are anchors, which are usually set in terms of comparables, which are reflections of other comparables, etc. etc. Even absurd anchor prices will operate on buyers so long as the seller is willing to wait for its magic to work.

Buyers of commercial real estate try to firm up the infirmity of pricing by determining the "intrinsic value" of a target property. "Intrinsic value" is defined in terms of its net present value (NPV), which can be calculated in several ways.

The general idea is that NPV represents a dollar number that takes into account all current costs of acquisition, all future costs (such as interest, maintentance and taxes) and all future cash inflows (such as rent). A discount rate (or hurdle rate) represents the buyer's required rate of return. When these factors are calculated in combination, a positive NPV indicates a buyer-favorable investment; a negative NPV indicates a buyer-unfavorable investment.

After all is said and done, however, Poundstone would say the research shows that a high anchor price for commercial real estate still pulls up the selling price, even though the buyer has done what he could to offset the effect of the anchor price by "considering the opposite" and using NPV in negotiations. The lesson here -- and the one that should be applied in all investments – is that when a buyer can't get it for the price that makes financial sense, the buyer should walk away from the deal.

Priceless was not written as a primer for how to price above value. It was, I suspect, written as an expose of how buyers can be manipulated. Consumer Reports tells you what things are worth. Priceless helps buyers pay that price, and no more.

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