



The effects of reference point, knowledge, and risk propensity on the evaluation of financial products [☆]

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ABSTRACT

Evaluating and choosing a financial product often requires a trade-off between risk and returns on investment, as a riskier product may yield a higher return. We examine the effect of different reference points (i.e., a riskier reference vs. a safer reference) on the evaluation of a financial product when attributes are explicitly traded off during the evaluation. Our findings suggest that a safer reference increases the attractiveness of the focal product under evaluation, while a riskier reference point does not affect that evaluation. The safer reference point appears to facilitate the risk-seeking tendency in financial decision-making. Further, two types of consumer knowledge, namely, objective and subjective, can moderate the effect of the reference point. Subjective knowledge negatively affects attribute-based objective evaluations, promoting instead the use of external reference information. A discrepancy between the two types of knowledge (i.e., over-confidence), in particular, can cause a more biased evaluation.

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1. Introduction

According to a reference-dependent model (Tversky and Kahneman, 1991), a product is evaluated relative to its reference points. The product can then be perceived as either positively or negatively relative to these reference points, rather than for its actual monetary value per se. Studies have reported the effect of references in various contexts, including price evaluation (Howard and Kerin, 2006), brand choice (Dhar and Nowlis, 2004), nutrition labeling (Barone et al., 1996; Li et al., 2000), and fundraising (Berger and Smith, 1997).

The effect of reference points has been often investigated in the context of whether a focal choice is viewed as worse or better than a reference point (e.g., Chatterjee and Heath, 1996; Hsee and Leclerc, 1998; Zhang and Mittal, 2005). However, this comparison could be more complicated since assessing whether a choice under consideration is worse or better than a reference point is not always that simple or that obvious. For instance, when two brands are compared, with Brand A being more expensive, but of a higher quality, and Brand B being less expensive, but having a lower quality, if both price and quality are considered, then it is not as simple a process to judge Brand A better than Brand B or vice versa.

Evaluation often involves trade-offs between attributes (e.g., price vs. safety when making a car purchase) (Luce et al., 2001). Previous

studies (e.g., Chatterjee and Heath, 1996; Luce et al., 1999; Simonson and Tversky, 1992; Tversky et al., 1988) have investigated attribute trade-off, but little research has yet examined the effect of reference points on the attribute-based evaluation.

In particular, we examine the effect of a reference point on financial decision-making. Evaluating and choosing a financial product often requires a trade-off between risk and returns on investment since a riskier product may yield a higher return. In a similar, specific decision-making context, we examine the effect of reference points on the evaluation of a focal financial product, testing three reference conditions: no-reference, a riskier reference point, and a safer reference point.

Further, since previous research suggests that external information use varies based on the level of consumer product knowledge (see Alba and Hutchinson, 2000 for a review), and risk propensity affects the evaluation of risk (Sitkin and Pablo, 1992; Sitkin and Weingart, 1995), we investigate whether the reference point effect is moderated by consumer characteristics of knowledge (both objective and subjective) and risk propensity. We report the findings from an Internet-based experiment and draw implications from these findings for marketers of financial products and also consumer financial counselors and educators.

2. The effects of riskier and safer reference points

The evaluation of any financial product involves a trade-off between its positive and negative attributes. For instance, greater returns require longer commitment and may be offered under a condition of limited fund accessibility (e.g., no withdrawal option with

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certificates of deposits). The first hypothesis for our study addresses the effect of a reference point provided for comparison purposes during the evaluation of a financial product that involves a trade-off between attributes (i.e., return on investment and accessibility or lack of accessibility to the investment fund).

Previous studies have not provided a clear prediction of how a reference point influences the perception of a focal choice when the evaluation involves explicit trade-offs among attributes. Brenner et al. (1999) and Dholakia and Simonson (2005) suggest that comparison to a reference point can negatively affect the evaluation of a focal product. However, these studies argue for the negative influence of a reference point in the context of simple comparisons between choices when the information on relevant attributes was not actually being reviewed; thus, attribute trade-offs could not be made in such an evaluation (e.g., comparing Brand A to Brand B without quality/attribute information).

With financial products, monetary earnings (e.g., interest) are evaluated in light of the attribute of uncertainty. For example, locking into a savings account for a certain set period of time could provide a higher interest rate, but it could also stress one's financial portfolio by limiting fund accessibility, thus increasing uncertainty. Our first hypothesis addresses whether providing a reference point for comparison purposes will increase the attractiveness of a focal product. Normative judgment would predict a consistent assessment of risk and return for a financial product whether a reference point is provided for comparison purposes or not. However, when the specific attributes that are being traded-off are considered, the provision of a certain reference point can change the evaluation of the focal product because of cognitive difficulties on the part of the decision-maker during the attribute trade-off process (Luce et al., 2001).

According to prospect theory, the tendency of loss aversion predicts a risk-seeking tendency in the negative domain, but a risk-averse preference in the positive domain (Kahneman and Tversky, 1979). A decision that can lead a person to give up his or her property or asset has been framed as a loss in the previous literature (e.g., Aggarwal and Zhang, 2006; Nayakankuppam and Mishra, 2005). Thus, an investment decision that bears the risk of monetary loss or blocks accessibility to funds might trigger a risk-seeking tendency. We propose that providing a safer reference point with a lower return will increase the attractiveness of the focal product since the focal product will then be perceived as having a higher return with more risk when compared to the safer reference point with a lower return. The focal product will then be evaluated more favorably, compared to its evaluation without a reference point.

On the other hand, a riskier reference point (more uncertainty) with a higher return will cause the focal product to be perceived as safer with a lower return; that is, the product under consideration will be perceived to have less uncertainty, which then cannot stimulate a risk-seeking tendency. We do not expect a similar positive effect from a reference point when it is riskier. Therefore, based on the prospect theory, which posits a risk-seeking tendency under uncertainty, we hypothesize the following effect:

H1. A safer reference point with a low return will increase the attractiveness of a financial product, while no such effect will occur with a riskier reference point with a higher return.

3. Moderating effects of knowledge and risk propensity

We examine whether the reference effect on the evaluation of a financial product that was proposed in H1 varies based on the level of consumer knowledge. Previous studies distinguish two types of knowledge, i.e., objective knowledge and subjective knowledge, as well as their effects on choice and information search behaviors (for a review, see Alba and Hutchinson, 2000; Moorman et al., 2004). Objective knowledge here refers to “accurate stored information,”

while subjective knowledge is a subjective “belief about that state of knowledge” (Moorman et al., 2004).

The literature has demonstrated the role of objective knowledge in information processing (Alba and Hutchinson, 2000; Mandel and Johnson, 2002). Alba and Hutchinson suggest that experts are more likely to do schema-based information processing than are novices, while novices rely more on external information. Empirical studies have demonstrated that experts perform attribute-based information searches (Brucks, 1985) and product evaluations (Cordell, 1997), while novices are more influenced by contextual information and the information presentation mode (Bettman and Sujan, 1987; Mandel and Johnson, 2002; Wright and Rip, 1980). Accordingly, we expect that experts will be less influenced by reference points; their evaluation of a focal product will be based more on weighing its positive and negative attributes, regardless of the presence of a specific reference point. Thus, we propose the following moderating effect of objective knowledge:

H2(a). The effect of a reference point on the evaluation of a financial product (H1) will be greater for those with low objective knowledge than for those with high objective knowledge.

We propose that the effect of subjective knowledge moves in the opposite direction. Subjective knowledge reflects one's confidence in one's personal knowledge (Brucks, 1985; O'Casey and Pecotich, 2005), which can create a systematic bias in decision-making. Brucks (1985) reports that those with high subjective knowledge tend to rely on evaluations of the referent (e.g., dealer opinions on a car purchase) rather than attribute-based evaluations. Subjective knowledge increases the extent of an external information search (Srinivasan and Rachford, 1991), and that reliance on external and contextual information will cause those with high subjective knowledge to be more affected by a reference point. Thus, the following moderating effect of subjective knowledge is proposed:

H2(b). The effect of a reference point on the evaluation of a financial product (H1) will be greater for those with high subjective knowledge than for those with low subjective knowledge.

Previous studies suggest that objective and subjective knowledge can have opposite effects, as hypothesized in H2(a) and H2(b) here. It should be noted as well that a dissonance may exist between objective and subjective knowledge. The previous research has reported on the various degrees of correlation between these two types of knowledge, including no significant correlation (Ellen, 1994), low correlation (.05), and high correlation (.65) (see Moorman et al., 2004), and thus, we examine the degree of correlation between the two types of knowledge for this study's participants. If a certain degree of discrepancy exists between the two types of knowledge, and their effects are opposite as hypothesized, we can speculate a three-way interaction effect, namely, that the effect of reference information will be greatest with the condition of low objective knowledge and high subjective knowledge. Thus, in addition to the two-way interaction effects mentioned earlier, we further examine how a possible discrepancy between the two types of knowledge may affect the reference effect (H1) by testing a three-way interaction term (reference information \times objective knowledge \times subjective knowledge). To our best knowledge, such discrepancies between these two types of knowledge have not been specifically investigated empirically in previous studies.

We propose risk propensity as another moderator. Risk propensity is “the tendency of a decision-maker either to take or to avoid risks,” which is domain specific (e.g., financial risk, physical risk, and social risk) (Sitkin and Pablo, 1992). Our conceptualization of risk propensity references a relatively stable individual trait in personal financial management, comparable to the chronic risk preferences identified in Hamilton and Biehal (2005). The extant empirical research on the role of risk propensity has been limited; among the few studies, Sitkin and

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