FINANCIAL INVESTMENT ADVICE THAT ALLOWS FOR REFERENCE-DEPENDENT PREFERENCES

Bas Donkers
Erasmus School of Economics, Erasmus University Rotterdam

Carlos J.S. Lourenço
ISEG – Lisbon School of Economics and Management

Benedict G.C. Dellaert
Erasmus School of Economics, Erasmus University Rotterdam

Daniel G. Goldstein
Microsoft Research, New York

Abstract

A primary objective of investment advice is to accurately match financial products to consumers' preferences. Typically, the matching is based on a measurement of consumers' trade-offs between investment risks and returns, which then guides the selection of an investment portfolio on the market's efficient frontier. However, beyond risk-return trade-offs, consumers also often wish to mitigate potential low returns with respect to a reference point. For instance, they may not want to end up with an amount that is below a target outcome. To allow for the impact of such reference-dependence in risk-return preferences, this paper proposes a new investment profiling method that combines interactive, frequency-based risk preference elicitation with reference-dependent utility model estimation. The method can be used by firms that wish to generate investment advice that allows for preference discontinuities due to reference-dependence. The results of an incentive-aligned empirical study and a simulation analysis illustrate the importance of reference points as a critical component of consumers' risk-return preferences. The paper discusses implications for financial advice in terms of balancing the goals of optimal risk-return preference matching and reference-point based mitigation of low outcomes.

Keywords: financial advice, reference-dependent preferences, risk profiling, interactive preference elicitation, risk mitigation