RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Financial professionals, retirement plan advisors, researchers.

Institute Research Agenda Topic:
Understanding differences in consumer behavior and decision-making.

Definitions of **bolded key terms** are at the end of this article.

DR. KREMENA BACHMANN
is a behavioral scientist at the University of Zurich and at the Zurich University of Applied Sciences. She studies how psychological effects influence individual decision behavior. Her research focus is on designing measures that can help individuals make better financial decisions for themselves. To learn more, visit https://www.zhaw.ch/en/about-us/person/bahm.

Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Kremena Bachmann. 2018. "Can Advisors Eliminate the Outcome Bias in Judgements and Outcome-Based Emotions?" Review of Behavioral Finance 10 (4): 336–52. https://doi.org/10.1108/RBF-11-2016-0072.

Insight: CAN FINANCIAL PROFESSIONALS HELP CLIENTS LEARN BETTER FROM THE OUTCOMES OF PAST DECISIONS?

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

Financial professionals can help clients understand that financial advice, even when it is good advice, can result in bad outcomes. But a financial decision that a client makes after consulting with a professional can result in a strong emotional reaction if the decision results in losses; that reaction that can be even stronger than if the client had made the decision without advice. If clients experience loss from an investment after receiving advice from a financial professional, it is not enough for the professional to explain why the advice is nevertheless valid. Doing so improves clients' understanding that good advice may have bad outcomes, but it will not necessarily encourage clients to keep following good advice even after losses. To help clients avoid changing their decisions for no good reason, financial professional should consider the emotional aspects of clients' decisions, which may be related to what clients have expected from following the advice.

PRINCIPAL INSIGHTS

Usually, good (bad) outcomes are the result of good (bad) decisions. If no other information is available, it is reasonable to use the outcomes to judge the quality of the underlying decision processes. When information regarding the quality of the decision process is available, however, we should consider that information instead of the outcomes in judging the quality of the decision process; this is true particularly when the outcomes are influenced by chance. An **outcome bias** can occur when individuals evaluate their decision based on the outcome of the decision and not on the information available to judge the quality of the decision process. With outcome bias, people might not revise bad decision processes if they happen to be lucky, or they might abandon logical reasoning if they happen to be unlucky. What can **financial professionals** do to help their clients draw the right lessons from both good and bad outcomes?

Kremena Bachmann's article suggests that financial professionals who provide advice and thus reduce the uncertainty around choosing the best alternative can eliminate outcome bias.[1] This uncertainty can be substantial, especially when people make investment decisions with risky assets. To eliminate this uncertainty and study what people learn from the outcomes of their investment decisions, the author set up an online experiment with students at the University of Zurich. In this experiment, participants were asked to make investment decisions in four rounds. In each round, participants chose from among four different investment alternatives. Each investment alternative had three possible payoffs—high, neutral, or low—with the payoff at the end of each round decided by chance. The possible payoffs were designed in such a way that one of the investment alternatives was better than the others. Participants

Retirement Income Institute Insight-#035-2021. © Alliance for Lifetime Income

were incentivized to find the best investment alternative: their compensation for participating in the experiment depended on their investment performance.

To study the effect of advice on judgements, participants were randomly assigned to one of two groups. One group of participants made investment decisions without any advice and the other group made investment decisions with the help of a financial professional. The professional recommended the best investment alternative and explained why it was better than the alternatives. After completing each investment decision and observing its outcome, participants were asked to assess the quality of their decision and whether they would decide the same way again. Participants were also asked to assess the quality of the advice that they had received.

The first goal of the study was to analyze whether professionals can teach their clients that high and low returns are decided by chance and that clients should focus on the reasoning that underlies the decision when making a choice, and when judging whether the decision was good or bad. The results revealed that it is indeed possible for professionals to teach their clients this message. Participants in the advised group judged the quality of the received advice and their own reasoning equally when the outcome of their decision was low, neutral, or high. In contrast, after observing random low outcomes, participants who made their own decision without help judged the quality of their own reasoning as lower than they did when they observed neutral outcomes. This observation suggests that professionals who eliminate the uncertainty in decisions can also eliminate the outcome bias in judgements, in particular when the outcome is bad.

The second goal of the study was to investigate whether having certainty that a particular choice is the best one increases confidence in the underlying decision. The analysis showed that the willingness to make the same decision again increased after high outcomes in both groups. After low outcomes, the willingness to decide the same way decreased in both groups, but the decrease was significantly more pronounced in the advised group than it was in the group that had not received advice. These observations suggest that financial professionals eliminating the uncertainty in the decision quality can help clients understand that good decisions can lead to bad outcomes just by chance. Financial professionals are not able to prevent affective reactions after bad outcomes, however. On the contrary, the affective reaction of clients after bad outcomes is even stronger when they follow the advice of a financial professional than when they decide without a financial professional.

The results of this study have important implications for professionals who want to maintain a positive relationship with their clients. Convincing clients that advice is optimal supports those individuals' understanding that good advice can have bad outcomes. This understanding might not prevent emotional reactions after bad outcomes, however. On the contrary, the affective response after bad outcomes is even stronger for clients who received advice than it was for clients who did not. Hence, financial professionals should address not only issues related to the quality of the provided advice, but also issues related to the emotional aspects of the decision. These emotional aspects could be related to what clients expect from following the advice.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

financial professional: *A qualified person who can help you understand your options and make financial decisions to work toward your financial goals.*

outcome bias: *Outcome bias arises when a judgement whether a past decision was good or bad is based on the outcome of that decision and not on the quality of reasoning that motivated the decision. People with an outcome bias systematically neglect the role of chance (i.e., that good decisions can have bad outcomes and bad decisions can have good outcomes).*

For industry use only.