Graham Bentley

explains the importance of offering value in the current climate.

perceptions of value

April 2009

> "A bargain is something you can't use, at a price you can't resist"
>
> Franklin P Jones

The spectre of recession, continuing depression in the property market, and deflation/inflation threats (depending on your time-horizon), are causing everyone to reconsider their attitude to money. We are more focused on costs now; how much should I pay for this product or service? Do I really need it? How will it benefit me? In other words we are concerned with value for money. Current and potential investors are no different, and your clients will be considering the service they are getting currently (ie losses) versus the costs associated with it.

The terms value and price are interchangeable – what value did the estate agent put on my house? That becomes the price. However, we are only too aware that value is in the eye of the prospective purchaser – the price the buyer is willing to offer.

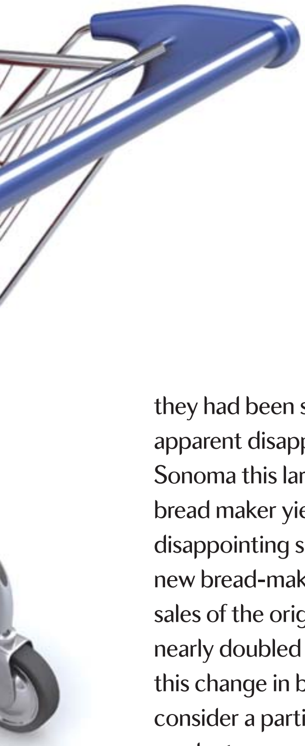
Value is often defined in terms of deviations from a reference point. For example, would you pay €25 for a burger? Imagine you're a typical American on vacation in Rome, Italy (I have to tell you the country because you're in character). Your partner decides you should both waddle across the Tiber and squeeze into Vatican City, the world's smallest country. Having missed your usual hefty breakfast, you find yourself in St Peter's Square at lunchtime. You are reminded that Vatican City is one of only five countries in Europe that doesn't have a McDonalds. You are starving. Then you catch the unmistakable, mouth-watering aroma (stay in character) of a Big Mac, wafting out of a bag held by a young chap next to you who's carried it on his Lambretta the mile from the Pantheon. He sees you wipe the saliva from your chin, and with a polite 'Diami venticinque euro, ciccione', he hands you the bag with a grin, while you hand over the cash, virtually sobbing with gratitude.

Price and value are variable and relative. What matters in any transaction is what the buyers can afford to pay and the satisfaction they expect to receive.

All Big Macs will not thereafter be worth €25 – just that one, that day. However, I will have a general expectation of Big Mac prices, based on my experience.

relative value

In other words, to determine value I might compare with the past. We are all familiar with this; the price tag that says 'was £999, now £499!' is often seen in department stores. It does not occur to us that the original price might have been inflated and used for a week in a shop in the middle of Bodmin Moor, solely to afford a discount everywhere else later. Another pricing tactic, however, is more powerful than you might imagine – to offer the chance to compare with a neighbour. A number of years ago, up-market US retailer Williams-Sonoma added a second bread-making machine to its product line in their popular kitchen retail stores. This new bread-maker was slightly larger and almost 50% more expensive than the original bread maker



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Graham Bentley
Head of Investment Marketing

they had been selling at the time. To the apparent disappointment of Williams-Sonoma this larger and more expensive bread maker yielded extremely disappointing sales figures. Yet, after this new bread-maker had been introduced, sales of the original, cheaper bread-maker nearly doubled in its stores. What explains this change in behaviour? When we consider a particular set of choices for a product, we may tend to favour alternatives that are 'compromise choices' — choices that are a compromise between what we need, at a minimum, and what we could possibly spend, at a maximum. When making a decision between a low-priced product and a moderately-priced product, people will often compromise with themselves by holding back on the more expensive product, choosing instead to opt for the less-expensive version.

Another problem associated with perception of value relates to the *illusion of temporal perspective*. Investors have great difficulty in recognising value over time. For example, suppose I offer you £60 versus £50. Obviously more is better than less so you take the £60. Alternatively I might offer you £50 now, versus £50 in a month. You'll take the £50 now, because now is better than later – you expect your waiting time, the time you do not have use of the money, to be compensated for. So the question is what is the level of compensation required? I now offer you £50 now, or £60 in one month. Despite the fact that the £60 in one month represents a 20% return over £50 now, most people take the £50 in experiments. In fact, the interest has to be in the thousands of percent to compensate for the waiting, for such a nominal sum. Finally then I offer you £50 in 12 months, versus £60 in 13 months. In this case most people are prepared to wait that extra month, and take the £60 option. But as we have already identified in the previous example, investors generally prefer now rather than later – 12 months from now they'll change their minds and take the £50.

losses and gains

As if these weren't enough, the decisions we make regarding value can be manipulated by the way choice is presented in terms of losses or gains. Credit card companies profit by promoting cash discounts rather than credit card surcharges, because even though the fee structure is equivalent in both cases, surcharges are viewed as out-of-pocket losses, whereas cash discounts are viewed as gains*. Ask your clients about investing in UK equities with the following statements 'by investing in UK Equity funds over the last five years you had a 60% chance of positive returns. Would you invest in UK Equities?' Alternatively 'by investing in UK Equity funds over the last five years you had a 40% chance of losing money. Would you invest in UK Equities?' Both statements are correct** but the second is more likely to persuade investors to avoid that asset class.

Given stock market returns over the last ten years, the cult of the fund manager may be less fashionable, with advisers feeling under pressure to refocus their attention on price. Relatively low-cost passive investments are attracting very positive press and dramatic increases in new business.

However, the means by which much of that business is transacted, ie platforms, must also be included in that price refocus. As we have seen, price and value are concepts that are not straightforward, and opportunities to confuse and obfuscate abound. We should reconsider how customers think about price, and what value actually means – to them, and to adviser businesses.

helping you to add value

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Visit **www.skandiapricewatch.co.uk** to find out how the leading UK platforms compare on price.

Visit **www.skandia.co.uk/fasite/solutions/spectrum.asp** to find out how Skandia's risk rated funds can help clients understand what they expect to receive from their investments.

*Thaler R (1980) Toward a positive theory of consumer choice Journal of Economic Behaviour and `Organization, 1, 39-60.

**Of 376 UK Equity focused funds with a five year track-record on 30 March 2009, 221 funds had given a positive return. Source: Financial Express Analytics.