Save it or spend it? Advertising decisions amid consumer word-of-mouth

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Most people have seen or heard from a friend, neighbor or family member about a product or service they've used and how their experience was. It's called observational learning or word-of-mouth.

These communications don't provide an unbiased assessment of true quality. Given this, businesses are faced with the difficult decision of determining when and how to spend their ad dollars. New research in the INFORMS journal *Marketing Science* finds when consumers learn about products/services from other consumers, a business may actually want to spend more money to credibly signal its quality.

The study, "When Consumers Learn, Money Burns: Signaling Quality Via Advertising with Observational Learning and Word of Mouth," details that word of mouth and advertising are not the same. Word of mouth is believed to be "free" advertising; but this may not always be the case. In fact, the opposite may be true when the role of advertising is to credibly signal product quality to consumers.

Word-of-mouth interactions may involve underreporting (not everyone shares experiences), positive reporting (when positive experiences are communicated more widely than negative ones) or negative reporting (when negative experiences are communicated more widely than positive ones).

"While both word of mouth and advertising can provide information regarding quality to consumers, one would suspect a high-quality business should have to spend less on advertising as it would benefit from word of mouth," said Yogesh Joshi, a professor at the University of Maryland. "However, this research shows that word of mouth, rather than softening the need for spending on advertising, may require a high-quality business to allocate more resources to these quality signaling efforts."

Joshi and his co-author Andres Musalem of the University of Chile and Instituto Sistemas Complejos de Ingeniería (ISCI) say the benefits for a low-quality business force a high-quality one to spend more on advertising, to prove their worth and that their quality is better than the low-quality business that's getting traction from word of mouth.

"When all consumers share their experiences, a high-quality business may be better served by reducing its investment in advertising, and in certain cases by a lot," said Joshi. "Further, as more negative experiences are shared, it can be optimal for a high-quality business to spend more on advertising because as the sharing of negative experiences increases, some late consumers who would have otherwise been exposed to no experiences are now exposed to complaints."

When quality differences across types are not too strong, and consumers share more complaints, the researchers say a high-quality business may need to allocate more resources to its quality-signaling advertising efforts.

More information: Yogesh V. Joshi et al. When Consumers Learn, Money Burns: Signaling Quality via Advertising with Observational Learning and Word of Mouth, *Marketing Science* (2020). DOI: 10.1287/mksc.2020.1246

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