Taming your inner bear

Behavioral economics explains a lot about investors' jitters over the pandemic, and advisers who employ its insights can help clients avoid irrational decisions

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This year's volatile market has tested many investors, some of whom have been caught up in a panic and sold at significant losses.

Some have rebalanced their portfolios, favoring less risky investments. Others, if they have not had to consider dipping into their 401(k) accounts early, have stopped saving or investing.

And many have simply done nothing, which, depending on their age and investment strategy, is likely the best course they could take.

Behind the variety of responses are some basic concepts from behavioral economics, an understanding of which can help advisers and their clients respond better in uncertain times.

"It really depends on how many crises you've been through with skin in the game, for how people are responding to this as investors," said Sarah Newcomb, a behavioral economist at Morningstar Inc. "What we are experiencing started with fear. More than just market fear — it was survival fear, and survival fear is very motivating. What fear does in our brains … is it shortens our mental time horizon."

NOW VS. LATER

Fear often leads people to focus almost exclusively on their current circumstances, causing them to lose sight of the future. This is present bias.

"People really become very present-focused. While that might be great for meditation, it's not very great for investing. The first thing you must do as a long-term investor is see the future," Newcomb said.

[**Video: Brinker's Crosby: Dealing with the fear factor in unprecendented times**]

For some, that led to selling riskier assets, such as stocks and investments built with stocks, for fixed income. This year, there has also been strong demand for variable annuities that are designed to limit losses for contract holders.

"In that immediate shock of stress and fear and panic, many people experience a huge preference for certainty in the moment, no matter what the cost," Newcomb said. "We are so uncomfortable with that uncertainty."

However, there is a different behavior that is also at play — one that conflicts with panic selling.

"People tend to hold onto losses for too long, because they feel they missed out on selling [securities] when the price was still kind of good and are hoping it will come back," said Nina Mazar, a behavioral scientist and professor of marketing at Boston University. Similarly, some investors sell gains too early, Mazar noted, citing research published more than 20 years ago by Terrance Odean and Brad Barber.

"A very common scenario is when a client owns a stock or fund that's in the red and is hesitant to sell until it comes back to breakeven. When asked why, the responses are usually either to avoid the feeling of taking a loss or an attachment to the original reason that led them to that investment," Steven Chau, founder of Know Your Worth Financial, wrote in an email. "That simple question of 'why' is usually all it takes to put that decision into context … [providing] the closure they need to move on from that position and begin exploring other opportunities."

Some investors have the opposite of a panic reaction to fear, instead taking on more risk than they would in normal times, Newcomb said.

"Suddenly, people who thought of themselves as decent investors four months ago think of themselves as investment geniuses now. And they're picking individual stocks, where they're probably better suited in target-date funds," she said. "There are good investments in the moment, but it's not about speculating. It's always got to be about the fundamentals."

The sense of urgency that investors have felt this year is "often a reactive, not responsive approach," financial adviser Megan Kopka of Kopka Financial tells clients.

"This is what we train for in investment advising and [train] better for in financial planning," Kopka wrote in an email. "I do not take on an investment client unless they go through my financial planning process so we have a plan for adverse market conditions."

MAINTAINING STATUS QUO

Prospect theory from Daniel Kahneman and Amos Tversky says people tend to overvalue what is happening in the moment, comparing any changes within a short window of time.

So even if a portfolio has seen a net return over a year, an investor might be more concerned with its performance over a month.

"It's very rare that we will look at the absolute gain or loss, but we always compare it to something," Mazar said. That can also mean waiting to get back into the market until stock prices fall back to low levels, as people who didn't buy at the bottom think they missed out on the best possible deal, she noted.

“Investors will actually use that as their comparison point, those really, really lows,” Mazar said.

“So they may be waiting now to get back into the market, because all these [recent returns], compared to those lows, are really high,” she added.

It is also human nature to view our actions in the context of what others are doing, Mazar said. If other investors are cashing out, for example, it can be uncomfortable to stay invested because it feels as if the person is doing something wrong by going against the group, she said.

“Clients enjoy learning how their current decisions relate to popular behavioral finance concepts,” Dan Andrews, vice president of Financial Planning Fort Collins, wrote in an email. “When Bitcoin was in the news all day every day in 2017 and 2018, clients appreciated learning about herd behavior and how that was influencing their desire to join the craze.”

LOSSES STING MORE

Prospect theory finds that losses sting more than twice as much as returns feel rewarding. Because of that, people are more likely to try to avoid losses than they are to seek gains.

“People are risk-averse. They are usually likely to pay a premium to avoid a risk,” Mazar said. “Regret is a very strong emotion. That is usually what guides our behavior when it comes to financial decision-making.”

People are afraid of what might happen in the stock market later this year, according to a recent survey from Allianz Life. More than half — 54% — of the 1,000 people surveyed in May said they are worried that the market has yet to hit bottom, according to the report.

Seventy-two percent of respondents said the recent volatility is making them consider changes to protect their retirement accounts from losses. More than half of the people surveyed said they have reduced the contributions they make to their retirement savings accounts.

And nearly half — 45% — said they preferred financial products that forgo some potential returns in exchange for limiting losses, up from 38% of people who expressed that preference at the beginning of the year, according to the survey.

“[COVID-19] was harder than most downturns to coach clients and employees because it was so fast and the health care piece was so uncertain. The panic was worse than normal,” Mark Struthers, founder of Sona Financial, wrote in an email. “Investors will often say, ‘I wish I were in cash,’ without reconciling the fact that they would have a fraction of their assets that they have now.”

Many advisers recommend against clients checking their account balances daily, as declines can induce panic.

“We try to educate them on why we made their investment in the first place and that nothing has changed our end goal,” Joseph Weber, president of Integrated Financial Solutions, wrote in an email. “Chasing returns is not a strategy, and we also try to coach them on tuning out all the noise they hear/see on the news.”

401(k) TRADING

During the crisis, defined-contribution plan participants traded in their accounts at the highest levels in more than a decade, reports from several plan record keepers show. But even so, the vast majority of plan participants didn’t touch their accounts.

“When we experience short-term, downward market volatility, we’re wired to act or make changes, but the market tends to reward inaction,” Matt Cooley, founder of Inspire Wealth Partners, wrote in an email.

While it's not clear what motivated investors to ride out the market, behavioral finance concepts that have been applied to 401(k) plans could be at play.

"When it comes to human behavior, it's about friction — what is easy, what is hard," Mazar said.

Avoiding hard decisions or ones that require effort is tied to the idea of inertia, which tends to make people stick with defaults. That concept has been credited with the success of automatic enrollment and automatic annual contribution increases — by doing nothing, workers begin building retirement savings.

But if enrolling in a plan is easy, making changes to it can be difficult, Mazar said. For example, it takes effort to log into an account and rebalance one's investments — and such a change might not take effect until the following pay period, she noted.

"As you have friction in terms of changing the allocation, the login to maintain, the less people will be engaged with that. And that can have its advantages," she said.

LEARNING OPPORTUNITY

The pandemic has had extreme economic consequences for millions who lost their jobs or had their hours cut, and that has highlighted the lack of emergency savings in the U.S. Though the federal government has provided unemployment benefits under the CARES Act, some people have had to turn to their 401(k)s for cash, well ahead of retirement.

The need for financial education is behind the lack of savings, but economic inequality is another major contributor.

"If you have present bias, then when you get money, you're more prone to spend it rather than save it for the future," Newcomb said.

"People who don't earn a living wage tend to have more present bias … [If] you can't see next week, you're not going to be planning for five years," she said. "Long-term financial goals are irrelevant."

Some advisers have extended free financial planning services to people experiencing hardship. For them, and for those with existing clients, this could be a time to educate.

"Advisers have such a great opportunity right now to teach, because people are listening," Newcomb said. "Under everything, what people need to learn is that long-term solvency is built on short-term solvency."

[Video: Brinker's Crosby: 3 steps to being a better behavioral coach in the age of COVID-19]

The reactions people have to volatility seem to be connected to their relationship with money, Danny Michael, principal of Satori Wealth Management, wrote in an email.

"People's biases toward spending, saving and investing typically begin in their childhood and carry on during their adult lives," Michael said. "It is crucial to understand these feelings upfront to ensure that I am able to make good investment recommendations consistent with the best interest of the client while accounting for their feelings toward risk."

To examine those deeply ingrained feelings about money, financial therapy is beneficial, wrote Tara Unverzagt, founder of South Bay Financial Partners.

"Behavioral science only takes you so far, and then you have to start diving into the 'stories in your head,' which is Financial Therapy," Unverzagt said. "Often they are family stories that are passed from one generation to the next, while other times they come from events or situations in your past where the story helped you, and now you are still hanging onto that story even though your situation has changed."