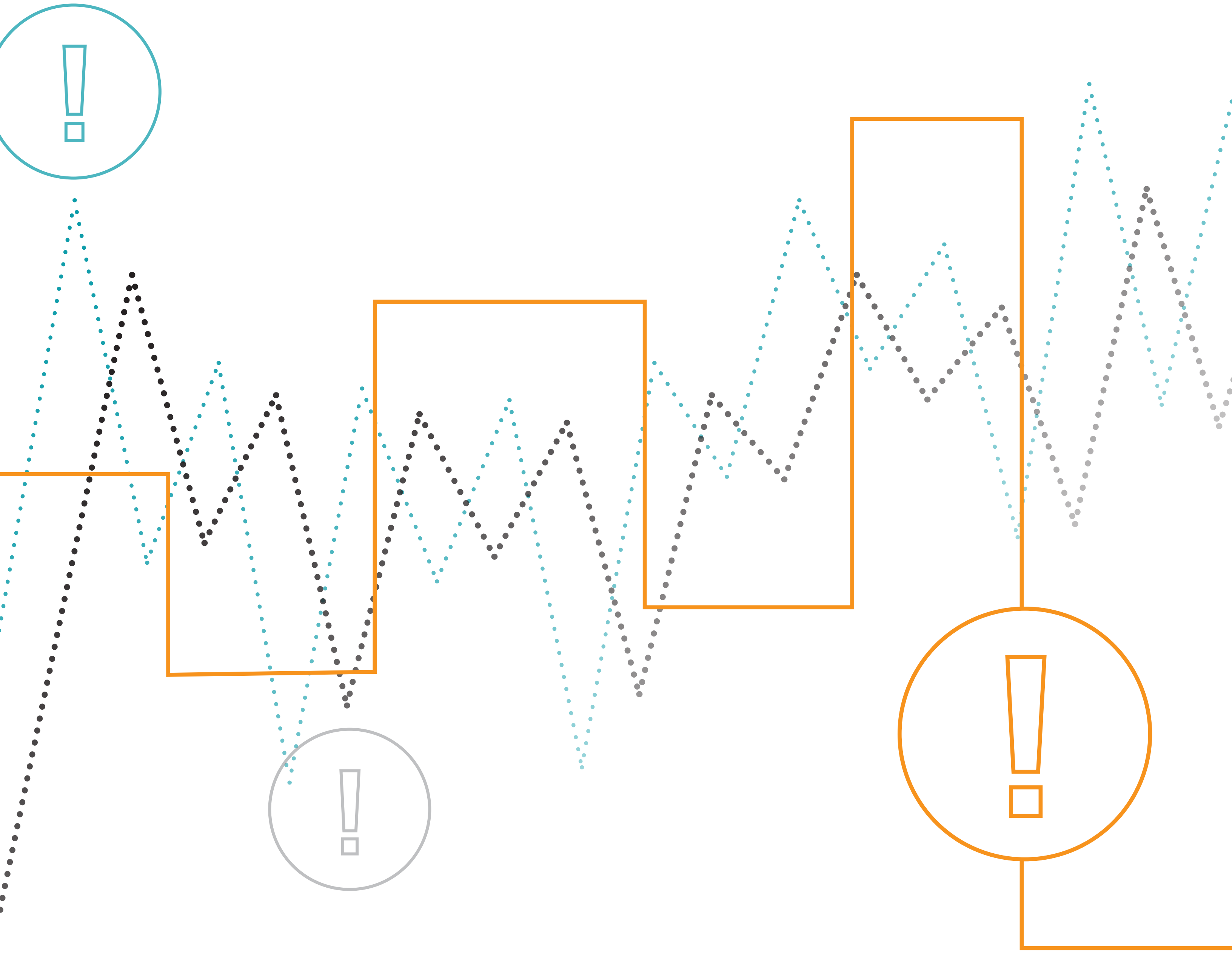
Morningstar Behavioral Finance for Advisors

Turning Volatility Into Positivity: Understanding Client Anxiety During Market Swings



The scenario is one that every advisor has faced: The market takes a tumble and clients are on the phone, wondering what's happened to their money, what the advisor is doing about it, and generally looking for assurance that all isn't lost.

"This can be driven by the fear of future loss," said Steve Wendel, Morningstar's head of behavioral sciences. "When someone has that fear, it's perfectly reasonable to call their advisor. And advisors have a key role as behavioral coaches to help their clients through moments like this."

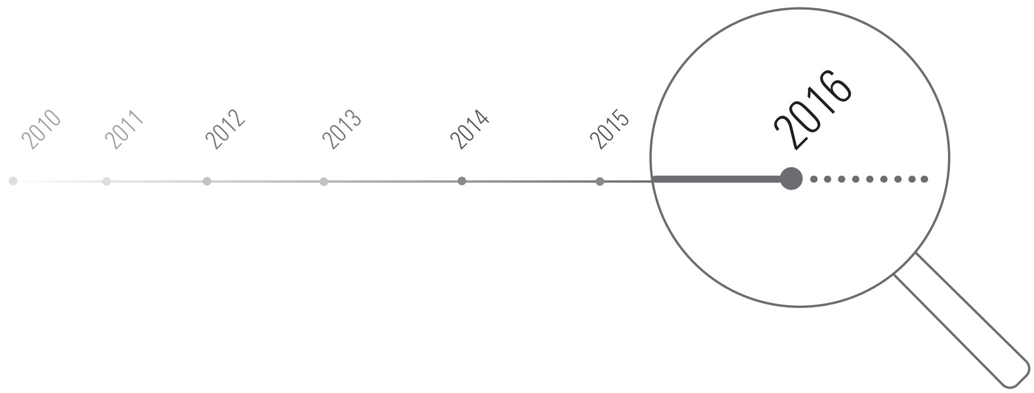
Helping clients through periods of market volatility can cement long-term relationships and keep investors on track to reach their goals. And successfully navigating these moments can be a lot easier if advisors understand the causes of investor anxiety and how to turn them into positive behavior. We shouldn't ask if the client is doing the right thing in that moment, but why that is moment happening.

Steve Wendel
Head of behavioral sciences

Steve Wendel is head of behavioral science for Morningstar, where he leads a team of behavioral scientists and practitioners who conduct original research to help people invest and manage their money more effectively. Before assuming his current role in 2015, he was principal scientist for HelloWallet, where he studied savings behavior and coordinated the research efforts of HelloWallet's advisory board. Morningstar acquired HelloWallet in 2014. His latest book, *Improving Employee Benefits*, shows HR practitioners how they can use behavioral economics to help employees to take action on their benefits. Wendel holds a bachelor's degree from the University of California, Berkeley, a master's degree from The Johns Hopkins University School of Advanced International Studies, and a doctorate from the University of Maryland, where he analyzed the dynamics of behavioral change over time.

The Mechanisms of Anxiety

Long-term investing discipline is so difficult for many people because the instincts that serve humans well in day-to-day life work against us when the stock market enters the equation. "We're hard-wired to see recent events as more predictive of the future than the distant past. If you think about our biases and the way we make decisions, they make perfect sense except when it comes to investing," Wendel said. "Investing is such a non-obvious, turned around scenario that we can get into trouble."



The first of these troublesome traits is recency bias: We believe that recent, especially vivid, events are likely to continue in the future.

"Recency bias is interesting. If you see the car in front of you crash, you should swerve. But if you see the stock in front of you crash, you should jump right in and buy the stock," Wendel said. "It's the exact opposite."

Recency bias and herding behavior are egged on further by the headlines and social-media doomsaying that accompany market volatility.

This bias is compounded by our brain's natural inclination toward herding behavior—looking at what other people are doing to get cues for what our response should be.

"If people are running out of the theater you should, too, regardless of whether you smell smoke. Get the heck out," Wendel said. "But with investing, if you see the herd going one way, that means there are opportunities in the opposite direction."

"When you see something like Brexit, you see investors say, 'Wow, all these other people are reacting this way, so I should too,' " Wendel said. "It's actually physically painful to resist the herd. We're social creatures. It's very hard for us to go against the social norm."

Recency bias and herding behavior are egged on further by the headlines and social-media doomsaying that accompany market volatility, making it far more "real" and immediate than a carefully considered long-term plan that a client agreed with years ago.

"You can have a calm, rational discussion with an anxious client about how market instability is probably going to be overblown, but if the client's neighbor is screaming about how we're all going to lose everything, that overrides everything else," Wendel said. "Vividness matters, and people often get excited about market volatility in part because of that vividness. The more vivid it is, the more real it feels.

"None of these biases is irrational or bad," Wendel said. "It's just a question of what you can do to help your client when anxiety strikes."

Turn Those Biases Around

When anxious clients call their advisor for reassurance after the markets fall, the vividness of the moment reigns. Yet, advisors can use this to everyone's advantage.

"What do you do? You can fight vivid with vivid. Give the most vivid example of other investors who gave in to herding behavior in the last major scare and then lost their house. Lost their retirement. Lost it all.

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"Then give a vivid, real, personal example about the people who stuck to their long-term plans through a scare and did really well," Wendel said. "The abstract is useless. It's about how well you can visualize that person who actually did it right."

The next step advisors can take is called anxiety reappraisal, which uses our natural response to stress to create positive behavior.

"It's very difficult for people to ignore their emotions when you tell them to just be calm," Wendel said. "Instead, you can tell them, 'Yes! Get excited!' You can relabel that emotional trigger as excitement. It sounds crazy, but it works.

"At its core, anxiety reappraisal is just saying, 'I'm excited about this. The reason I'm feeling this is because I'm excited,' when you're anxious," Wendel said. "You aren't going to tell your client to repeat 'I'm excited' over and over again, but you can say 'Yeah! I know there's a lot going on. Great! What can we do with this?' This strategy directs the energy from their anxiety into excitement.

“Contrarians do this really well. For example, Daniel Needham of Morningstar’s Investment Management group says, ‘Absolutely people are running away. This is the moment we’ve been waiting for.’ It changes the narrative from panic to opportunity,” Wendel said. Then, you can schedule regular check-ins with clients to help them stay focused on their long-term goals, instead of short-term panic.

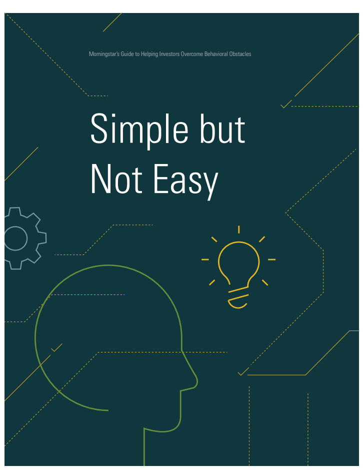
“You can’t tell people not to watch the news at all, but you can set up a replacement,” Wendel said. “Say, ‘We’re going to have quarterly check-ins. That’s when we’ll talk about your portfolio and its progress toward your goals. We will explicitly not talk about what’s happening to other people. We’re going to talk about you and your goals and your progress, not about a particular company in the portfolio that might be doing poorly, but the overall portfolio.’”

“So, when the client calls and asks what’s happening, you can say, ‘We set this up to move you toward your goals, and you’re doing fine.’”

Heading Panic Off at the Pass

The best way to handle anxious calls from clients is, of course, to plan for them ahead of time. That’s why Wendel recommends that advisors have each client write a self-addressed letter that outlines their strategic reasons for choosing a measured, long-term strategy.

Read Morningstar’s guide for helping investors overcome behavioral obstacles.



“In that moment of strength the client writes a message that says, ‘Hey, this is what I’m committing to. This is why. Read this when I’m tempted to stray,’” Wendel said. “That letter changes the conversation. It’s not about the advisor hectoring the client, it’s about the client reinforcing herself.

“You’re playing a mirror. A time-delayed mirror. Tell the client, ‘This is what you said. I’m not judging you—this is just what you asked me to give you.’ It changes the conversation.”

Rethinking the 'Invisible Client'

What about the clients who never call? While that might seem like a perfect scenario, Wendel said that it can cause just as many long-term problems as a client who's constantly asking for short-term fixes. And you can engage these "invisible" clients by simply reminding them about the existence of their financial life.

"Think about somebody who has a very robust work life, home life, and church life. When they're at work, they're generally not thinking about their home life and their church life. When they're at church, they're not thinking about their work life," Wendel said. "The same thing happens for investing. It's not because investing isn't important to them, it's because so many other things are crowding it out.

"One way to fix this is to simply re-engage. Try another moment, and check in. A client's lack of engagement means you're missing an opportunity to strengthen your relationship, which can mean much more to your practice than the bit of peace and quiet you get because they don't call when the market dips.

"Their marital status may have changed, their family status may have changed, or their work status may have changed. They may now be really excited about sustainable investing, but they haven't connected with you about it. They may be interested in retiring early, and you should say, 'Wonderful, I can help you do that.' That means more assets under management earlier, but it wouldn't have happened without that re-engagement."

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