portfolio construction forum

How to psychologically prepare clients for bear markets

Bob Veres | Inside Information | 17 June 2016

You're hearing dire predictions that the next major bear market is around the corner. Others say the bear is still a year or two away. But the truth is, the next bear market will come like the proverbial 'thief in the night' and none of us can predict the hour or day.

All we can do is prepare for it.

Preparing yourself and your clients for bearish times may be the most important investment activity you engage in – more important than portfolio design or research into actual investments – making money for clients during market downturns, by helping them avoid locking in losses and missing the recovery, and second, through consistent rebalancing.

The value of your efforts during bearish times can be seen in the disparity between investor returns and investment returns.

When Morningstar looked at the average 10-year total return for [US] investors in seven different investment categories through the middle of 2013, finding persistent differences amounting to 2.5 percentage points a year – primarily because investors abandoned a particular fund or the markets as a whole during downturns, and tended to buy funds after an anomalously good year or load up on stocks when the market was near its peak. The discrepancy was fairly consistent across asset classes: US equities, sector equity funds, balanced funds, international equities, taxable bonds, muni bonds and alternative investments, with the alternative investments actually squeaking out a 1% return while their investors lost money.

This follows a 2010 study where Morningstar analysts looked back at the decade of the "aughts" and found that [US] investors in mutual funds overall got a total return of 1.68% a year, while the funds they invested in returned 3.18%.

The best-known survey, the Dalbar Quantitative Analysis of Investor Behavior (QAIB for short) recently calculated a 20-year [US] investor return of 5.02% per annum versus 9.22% for the indices.

The disparity, depending on time periods and calculation method, ranges from roughly 1.5 percentage points to 4.1 percentage points a year.

Is there anything you can do with asset allocation, asset selection, tactical shifts or rebalancing activities that can reliably add this much return?

The question, then, is how to prepare clients so they won't give in to the herding instinct and sell out at the wrong time?

TALE OF THREE BRAINS

Ken Haman, managing director of The Advisor Institute at AllianceBernstein Investments, argues the challenge of navigating volatile markets is primarily psychological.

Haman, a former psychologist with a graduate degree in theology, says that it helps to understand that you, clients and all investors who are panicking as the bear claws its way through the markets are operating with three very different brains:

1. the Neo-cortex;
2. a set of ganglia below it that has the processing power of an unusually smart cat; and,
3. below that, at the top of the spine, a cluster of neurons which together possess roughly the thinking power of a lizard.

Nashville-based psychologist and coach Ted Klontz has estimated that the lizard brain and the cat brain together make 91% to 99% of all human decisions, no matter how rational we think we are.

"Whenever you reach a certain level of anxiety, the lower two-thirds will completely take over," Klontz explains. "The processing speed just overwhelms the cortex, and your rational thinking shuts down."

This prioritisation of decision-making has been extremely helpful for the survival of our species. If the highly-logical, slow-thinking cortex had been in charge of a Cro-Magnon hunter facing a saber-toothed tiger in the African Savannah, our ancestor might have admired the size and strength of the animal, and then thought for a few critical moments about the best strategy for evading the beast.

Should he run for the trees a few hundred yards away? That might take too long, but if he runs fast enough, there's a possibility he could be in the lower branches before the beast catches him. Or, alternatively, would it be a better strategy to run in the direction of the other hunters, who are not yet aware of the threat, but who could collectively face down the beast? He could yell while he runs, and his fellow hunters could run in his direction, cutting down the time of the chase. Would it be enough? By the time our unfortunate ancestor has fully considered his third option, the tiger would have pinned him to the ground and started chewing on his vital organs.

Panic and the decisions made by the lizard brain may not be the most rational approach to a problem, but they have the advantage of driving very quick and decisive decisions. Like, for instance, selling equities at any price when the markets seem to be in a death spiral.

Why is this important? "Because," Haman says, "our 'fast-thinking' reactive brain tends to see corrections as highly dangerous and potentially permanent."

Ordinarily, that wouldn't be a problem. But since the lower levels of our brains are many times more powerful than our 'slow-thinking' rational mind, they clamor with overwhelming force for us to take action to fix the problem. "Bear markets tap into the 'fight or flight' instinct that was originally designed to protect us from real dangers out on the world - like actual bears," says Haman. "Our fast-thinking, impulsive mind doesn't make much of a distinction between these two types of bears."

This explains why your best approach to helping clients through the next downturn is to apply psychological solutions.

PRACTICE THE NEXT DOWNTURN

One time-tested strategy is to desensitize clients in advance of the inevitable downturn, and practice how they'll face down the bear. Even if you can't predict the hour of its arrival, you can confidently predict the *fact* of its arrival. And then you can decide together how you'll handle it.

Haman recommends that you start talking now with clients about the inevitability of a future correction and how unpredictable such corrections are.

"We should have the humility to tell clients that we simply cannot predict the future and that we can only inoculate a portfolio to a certain extent through research and diversification," he says. "I recommend building this 'reality reminder' into every annual client review."

As the start of this year, portfolios were down roughly 10%, and the conditions seemed ripe for a lot more of the same. The Fed was on course to raise rates. There were scary slowdowns in China and Europe. The high value of the US dollar was squelching exports, we saw disappointing earnings expectations, and there was some kind of strange linkage between the markets and the declining price of a barrel of oil.

What were clients' instincts telling them to do (whether they'll admit it or not)? Point out that if they'd acted on those instincts, they would have locked in 10% losses and missed out on a nice 14% recovery.

So ask them - what will they do the next time the markets fall 10% and their instincts tell them to jump ship out of equities? What about 20%? Or, God forbid, 30%?

Since we don't know whether the next 10% drop is heading further down or back to where we were before, we can't maneuver in advance. But even if the markets tank like they did in 2008, do we really think that will be the first time in history that share prices go down and never recover?

TALKING TO THE LIZARD

The next bear market, whenever it arrives, could be much longer and deeper than the recent unpleasantness, and even battle-hardened clients will be looking over their shoulders for the next version of it.

"We think investors today are more vulnerable to over-reacting to corrections in the market than they were before the 2008 experience," says Haman. "Today, many investors still feel that the events of 2008 happened 'like it was just yesterday' and can vividly recall how upset they were. In behavioral finance this is called 'proximity bias,'" he adds, "in which a past event still defines the way investors think about current investment dynamics, even though current conditions bear no resemblance to the conditions that persisted during that previous time."

Is there a way to help clients neutralise their herd instincts in the middle of a prolonged downturn? Yes, but first you have to understand that your clients cannot hear your reassuring words when they're spooked by the markets.

"The Neo-cortex is the seat of two important functions - rational decision-making and language," Haman explains. "It's important to realise that the lower parts of the brain have no command of language."

When you're talking with a panicked client, Klontz recommends that you create a stress-free environment. "Just talking about money issues is stressful enough, even if there isn't a market decline going on," he says. Consider having your meetings on a couch instead of a formal conference room. Sit next to clients rather than across from them.

Meanwhile, Haman says we shouldn't give advice or preach the wisdom of the markets - at least, not right away.

"The worst thing we can do is criticise or disregard the strong feelings the client is having," Haman says. We typically want to speak about the mechanisms of the markets and help clients 'make sense' of what is happening. "It is important not to leap into these explanations before the client is ready to hear them," Haman adds. "Upset and impulsive clients do not want to hear, 'Calm down, we need to think long-term and stay the course!' This can actually cause the client to feel more threatened and decide you don't understand the gravity of the current situation."

Instead, Haman says, acknowledge that those feelings are present (and normal).

From there, Haman offers some techniques for redirecting your clients' thinking process from the faster to the slower, more rational sectors of their brains. Ask the client to describe how it feels.

"They can't hear you, so you have to listen," he says. "Asking a client 'how are you feeling right now?' or 'What do you think is going to happen?' or 'How do you think these things will come about?' all force clients to use their Neo-Cortex to understand the question and to fashion an answer."

The more you listen, the more they answer, the more clients start to become rational and able to communicate on a logical level. "String together several such questions in a step-bystep fashion and invest 10 or 15 minutes of listening to the client answer the questions," says Haman. "The result is usually a much more rational and less reactive client. Once the 'fast thinking' brain has been turned off and the 'slow thinking' brain is back in charge, then provide advice and guidance that the client will be able to understand, appreciate and follow."

And then?

"Once the conversation has returned to more thoughtful sentence patterns and the client is less distressed," Haman says, "begin to provide guidance about better ways to think about the current situation. It can be helpful to provide insights form the past and to describe historic precedents. Visuals can be helpful here, so long as they reveal key mechanisms and illustrate market dynamics clearly."

The goal, of course, is to separate your clients from the mindset of the herd.

Haman and Klontz both advocate the need to first separate yourself from the panicked herd mentality. Many times, we assume we are immune from fear, but if you think back to how you were feeling in late 2008, you know that isn't true. Make sure you're rational on your end of the conversation before you start trying to address the emotions of clients.

Alas, even as you skillfully master these tactics, all you can deliver is 1.5 percentage points to four percentage points a year. But in the context of investing, that's a considerable advantage over the rest of the herd.

And there may be other benefits that you can gain from these techniques. "Effectively helping a client weather the storm through frequent contact, effective conversation and sound advice will not only open up the opportunity to respond to opportunities more rapidly," says Haman, "but will gain the client's appreciation when markets regress back toward normal. Weathering the storm together builds stronger bonds."

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