

How to Minimize Your Clients' Panic During the Market Sell-Off

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This article is relevant to financial professionals and is not relevant to an individual investor. Individual investors should speak with a financial professional about their investing questions.

WisdomTree: Why do market losses lead some investors to act in a way that leads to even bigger losses?

Benartzi: When I try to explain why many investors overreact to market losses, I often begin by describing an old bet first introduced by the Nobel laureate Paul Samuelson. The bet involves a coin flip. If the coin lands on heads, you'll win \$200. However, if it lands on tails, you'll lose \$100. Do you accept the bet?

Most people reject this bet. That's because the pain of losing \$100 is greater than the pleasure of winning \$200. This is known as loss aversion, and it helps explain why a market full of investments that are losing money can be so unpleasant.

For many of your clients, however, the problem is even worse. These people aren't just loss-averse. They are extremely sensitive to *short-term losses*, a phenomenon Richard Thaler and I refer to as myopic loss aversion. If someone is myopic, they can only properly focus on things that are close by. Everything in the distance is blurry. Unfortunately, many investors are nearsighted when it comes to their investment performance—overly focused on recent events, even if it significantly reduces their long-term investment performance. These are the clients at highest risk of costly panic selling during a downturn, which is what has led, over time, to even bigger losses.

WisdomTree: You've developed a new tool that can measure an individual's level of myopic loss aversion. Could you tell us what it measures?

Benartzi: We ask a variety of questions focused on distinct subject areas. For example, some questions concern frequency of their investment feedback. Do they check their portfolio once an hour? Once a month? Once a year?

Another subject area involves how they react to setbacks involving a goal. Some people see setbacks as a sign they should choose a different goal. Others turn setbacks into motivational fuel and get more determined to accomplish their original goal. These questions draw from research on grit and persistence by Angela Duckworth and others.

And then there's the format of their investment feedback. Do they rely on quarterly paper reports? Or do they use dedicated investment apps? Although smartphones can make investing more convenient, that convenience can become problematic during periods of high volatility. That's because, according to the research, people tend to be more impulsive and emotional on mobile devices.

Depending on the answers of your clients, we can tell if they are at high risk for myopic loss aversion. For instance, a client who checks their portfolio every hour on their smartphone, and often changes goals, is at high risk, while someone who doesn't even read their quarterly paper statements is probably at lower risk.

WisdomTree: If they're at high risk for myopic loss aversion, what can you do?

Benartzi: The first thing you can do is help clients avoid looking at the market. If you're an advisor with clients who are myopically loss-averse, you should become a kind of "app doctor," helping them get investment feedback that encourages longer-term decision-making.

However, if your clients simply can't resist looking at the market, then it's important to take the following three steps.

The first is to help your clients zoom out and change the format of their investment performance screens. Use financial planning software that can display an account balance in terms of projected retirement income, as opposed to total wealth. Projected retirement income is much less volatile in response to market swings.

The second thing to do is to frame the market decline as a potential opportunity for your clients rather than a setback. Obviously, I don't know what the market will do tomorrow or next year. However, if appropriate for their investment strategy, the mere act of rebalancing portfolios amounts to a plan to buy more stocks that are possibly "on sale" as markets keep declining.

Finally, try thinking about the market correction in terms of simple actions your clients can take that can close the gap caused by the downturn. As I discussed in a related column in *The Wall Street Journal*¹, an investor with a portfolio that's 60% in stocks can potentially compensate for the market drop by making some small adjustments to their retirement plan.

Consider a process I call the 1-2-3 approach. If your client retires one year later than planned, saves just one percentage point more a year for two years, and reduces planned spending in retirement by 3%, they may erase the impact of the recent correction on their projected retirement income.

At times, your clients might feel like the only option for dealing with falling markets is to sell. However, by identifying those at highest risk of panic-selling and providing them with simple and positive actions, advisors can reduce the chance that they buy high and sell low.

¹Shlomo Benartzi, "Here's Why Some Investors Panic. And Here's How to Make Sure You Don't," *The Wall Street Journal*, Dow Jones & Company, 4/6/20.

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