The Drawbacks of Behavioral Finance During a Market Correction

The stock market got interesting again this week. Volatility is back after having gone missing for the past 18 months or so.

I saw the following words spewed across the financial media this week: turbulence, fear, pain, panic, distress, agony. It's still a little early for all of that. As of the close on Thursday, the S&P 500 is a little over 10% from its all-time highs.

But try telling that to your emotions when you're witnessing a decent percentage of your savings evaporate over the course of a little more than a week. The pain we feel from losses dwarfs the pleasure we feel from gains.

Because of the havoc they can wreak on our portfolios, investment professionals and advisors often instruct their clients to ignore their emotions during times like this.

Focus on the long-term.

Ignore the noise.

Disregard your fear.

Don't pay any attention to the markets or your portfolio.

This is generally good advice but it's incomplete.

Behavioral finance is still a relatively young field, but over the past decade or so it's gained a much broader acceptance across the finance industry in terms of how people view mistakes, human psychology, and irrational money decisions. Kahneman's Thinking, Fast and Slow has to be the number one recommendation whenever someone is asked about their favorite book on a podcast these days.

Although these ideas have become more mainstream, I still think there are people in the financial services industry who don't apply them correctly. The whole point of the field of behavioral psychology was to disprove the idea that humans are rational agents acting in their own self-interest. We're not robots but humans who are flawed (this is obvious but many in the field of economics didn't account for this idea for a long time).

But many are taking this knowledge of our inherent irrationality and expecting their clients and investors to ignore it all and act like, well, robots. We've come full circle.

We can't ignore our emotions. It's always going to be painful when we lose money. It may get easier over time through experience but those feelings will always be there.

Brendan Moynihan talks about this in his excellent book, *What I Learned Losing a Million Dollars*:

Emotions are neither good nor bad; they simply are. They cannot be avoided. But emotionalism (i.e., decision making based on emotions) is bad, can be controlled, and should be avoided.

Emotions are very strong feelings arising subjectively rather than through conscious mental effort. As will be shown shortly, the fundamental characteristic of a crowd is that it is exclusively guided by unconscious motives. In other words, it is guided by emotions. If you don't have conscious control of your actions, then your emotions have control of you. Therefore, in order to understand how emotionalism adversely affects you as an investor, trader, or speculator, you have to know the characteristics and behaviors of the crowd.

We're not all robots who can simply ignore our emotions or the news of the day. But Moynihan's point about having "conscious control of your actions" is a good one.

You have to understand that emotions will definitely come into play, especially when money is involved. And the higher the volatility in the markets, the higher the volatility of our emotions.

No amount of one-liners or Warren Buffett quotes are going to save you during a downturn if you haven't planned for it to occur ahead of time. That's like buying insurance after a disaster has struck.

The prep time for a market correction or crash comes well before it actually happens by:

- Setting realistic expectations.
- Mapping out a course of attack for when losses occur.
- Making decisions ahead of time about what moves (if any) to make and when depending on what happens.
- Deciding on the correct level of risk to be taken.
- Building behaviorally-aware portfolios.

Pinpointing our inherent foibles is only half the battle. The real work comes through building systems and plans that will keep those emotions out of your decision-making process. It's all about figuring out ways to work around your lesser self.

I'm not sure if this correction will prove to be short-lived or turn into a longer, drawn-out bear market. No one can predict how investors will react once things start to go down. But if you don't have a plan of attack in place going into something like this, your emotions will get the best of you.

Source:
What I Learned Losing a Million Dollars

Further Reading:
The Next Bear Market

Now here's what I've been reading lately:

- "The benchmark is “my family and I are alive, safe and fed”. The rest is luxury. (Dan Egan)
- 2018 is not abnormal in the markets. 2017 was (Planet Money)
- The best hedge there is (Reformed Broker)
- Investor, know what you control (Safal Niveshak)
- Narrative matter when speaking about the markets (Abnormal Returns)
- Why are people so loyal to their dentist? (Advisor Perspectives)
- Your true risk tolerance (Irrelevant Investor)
- This Quincy Jones interview...I don't even know what to say (GQ)
- Jimmy Buffett does not live the Jimmy Buffett lifestyle (NY Times)