The Fear Cocktail

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With the current state of the economy and the continual dramatic media reporting of the news du jour, financial advisors are witnessing an all too common pattern among their clients: financial behavior driven by investors’ emotions, not logic. Instead of making investment decisions based on reason and an understanding of long-term market behaviors and investment strategies, investors are finding themselves stuck in “flee or freeze mode,” unable to make sound financial choices for themselves and their families.

Financial advisors play an important role in helping their clients to understand and overcome the emotional state of mind that impact, and often prevent, their ability to make sound financial decisions. Educating investors on the realities of the various markets and discussing with them their current financial situations and levels of risk tolerance will better equip them to manage the situations at hand. The majority of investors turn to the daily news to follow the activity of the markets and learn the latest results from a variety of economic indicators, such as unemployment numbers, interest rates, GDP and the level of national debt. Without a comprehensive understanding of what is happening, why it is happening, and what it all means for their personal portfolios, clients often work themselves into states of panic. Having a knowledgeable and trustworthy advisor at their side can help investors avoid the trap of making rash and unwise emotionally based investment decisions. With understanding comes confidence and with this confidence, investors are better able to fight the temptation to flee or freeze.

“Flee or freeze mode” is an emotionally-driven investment approach that occurs when investors become so paralyzed with anxiety resulting from the fear of losing money or personal pride that they become incapable of making rational investment decisions. Instead of investing wisely, they simply do nothing, sometimes even as their life’s savings whittle away. Unfortunately, this inaction can often be more detrimental to one’s investment portfolio than adopting a purely aggressive investment strategy; many investors do not recognize that every investment approach involves a certain degree of risk, even if that approach is to do nothing at all.

When the external influences of society, whether economic, political, or social, meet the emotional needs of investors, such as the basic need for security and feelings of comfort, investors become locked in a constant struggle between the two forces. These two competing powers create “The Fear Cocktail”, a force that causes investor symptoms such as selling at the bottom of a market cycle and buying at the top, a behavior that is ruinous to a portfolio. A rational discussion between a client and his or her
The financial advisor should begin with how to best manage market fluctuations from the onset that will enable the client to progress from where he or she is today to where he or she wants to be in the future.

The first step in addressing the phenomenon of behavioral finance is to identify and confront the specific anxieties that are facing investors and influencing their investment behaviors. Some investors become paralyzed with the fear of making a wrong move that will result in a diminished financial portfolio, so they do nothing, providing them temporary feelings of self-preservation but costing them valuable investment opportunities. Others investors flee and are driven to sell assets at market lows. Both of these behaviors can lead to financial distress and in some cases, financial disaster.

The next step in overcoming the negative patterns of behavioral finance is to “know thyself”, a concept through which investors come to understand their current and anticipated financial needs. Once there is identification and understanding of these needs, clients can resign themselves to certain levels of investment risk, however prudent they wish these risks to potentially be. Risks in investing are often unavoidable, just as they are in life, but they can be calculated to a certain extent. A successful investment plan is one that assumes there will always be market fluctuations; the plan will adapt to these market changes as they occur. If the financial and investment climates change, so shall a well-designed and regularly monitored financial plan. The job of a financial advisor is to help his or her clients see the importance of investing over the long term and the causes and effects of their investment decisions. When the investor can begin to clearly see the path ahead, the ability to make effective decisions becomes far less stressful.

The final step in conquering the pull of behavioral finance is to actually map out the plan that is going to get an investor from where he or she is to where he or she wants to be. While it is impossible to predict specific market behaviors, once an investor has identified his or her needs, he or she can begin to develop an investment plan that will meet these needs. Investors are often hesitant to invest in a market that is up one day and down the next, especially as they approach retirement, but one of the most important things to remember about investing is that over the long term, these fluctuations appear as expected corrections on a steady road to investment success. The development and implementation of one’s financial plan and investment portfolio is one of the most important financial decisions a client will make during his or her investment career. These financial plans see many changes and alterations over the years as his or her circumstances change and life events occur, but it is this plan that will carry him or her from the early years in his or her career to a comfortable and enjoyable retirement. Because of this, financial advisors must, to the best of their ability, help their clients resist the temptation of investing based on emotion and not with their intellect. A great starting point in the discussions is showing the investors the possible ranges of returns that various fully diversified portfolio’s have experienced over a long period of time. When the data is concise and easy to understand, many investors are then able to free themselves from the anxieties they routinely experience and make sound financial decisions that effectively guide them forward towards their long term goals.

Unfortunately, there is no proven formula that financial professionals can apply to lead their clients from an emotionally charged state of mind to one that will allow them to make more rational financial choices. This is due to the varied and ever-changing emotions that run through clients’ minds, making their behavior inconsistent.
and therefore impossible to calculate. They wind up losing sight of the big picture as they run away with their emotions. Although investors’ emotions are difficult to predict and their behavior even harder to anticipate, every financial professional has a powerful tool at his or her disposal with which he or she can lessen the impact that clients’ emotions have on their financial decisions. This tool is empathy. Through empathy, financial advisors come to know and feel what each of their clients is going through and help him or her to navigate the specific fears he or she is facing. Feelings of empathy are achieved as the result of asking the right questions of clients, allowing them to explore themselves, their feelings, and the fears and other obstacles they are up against, and effectively listening to their answers. The combination of empathy, compassion, and financial knowledge enables financial advisors to free their clients from their repetitive investment errors and lead them toward a more sound and rational investment approach.

Only once an investor has confronted the factors causing his or her anxiety, developed an understanding of his or her comprehensive financial needs, and recognized the importance of taking calculated risks can he or she develop and execute an effective course of action toward building a financially healthy future. Emotions can never fully be separated from one’s mind and often cannot be subjugated by reason; therefore, dedicated financial advisors stay by their clients’ sides every step of the way. If the basic fundamentals are familiar to investors, the trauma of the almost incessant, spastic movements of the markets will cause little to no stress to them and they will be well on the way to making informed and calculated investment decisions.

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