The Three Factors of Fear

By Bob Veres
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Suddenly, in the past few weeks, the markets have looked a lot scarier to a lot of nonprofessional investors in the U.S. market. Why? The answer probably has something to do with human psychology.

As many of you know, an Australian company called FinaMetrica has been giving lay consumers a scientifically-designed risk profile questionnaire for the past 12 years, helping financial advisors evaluate whether their clients are natural risk-takers or the kind of people who feel more comfortable if their money is stuffed safely in their mattress.

A closer look at the responses, including 2,586 individuals who took the test before and after the recent bear market, shows something surprising: people were no more risk-averse after they had been clawed by the worst bear market since the Great Depression than they had been before.

Chances are, your clients less excited about taking market risk now than they were in, say, the early months of 2007, so these results seem impossible. But the FinaMetrica analysts offer a plausible explanation for their results: there are actually three very different components to your willingness to expose yourself to the ups and downs of the market. Two of them changed after the market downturn, and one of those two has recently changed again – at least for U.S. investors.

The first component is what might be broadly called your bravery; your willingness to take chances. This is the part that FinaMetrica measures directly, and its results show that if you were willing to skydive or take ski jumping lessons off the 90-foot hill before the Fall of 2008, you're just as excited by the idea of putting your life at risk now. The markets don't change who you are fundamentally.

The second component is your risk capacity; that is, how much financial risk you can afford to take. The 2008-2009 bear market might have caused a lot of us to rethink how early we might be able to retire, but a reprise of it might make us wonder if we can retire at all. So we become a bit more conservative in our investment approach.

Component number three is our risk perception. If we're watching the markets go up and up and up, then we see little risk and lots of upside. This is why, during the late 1990s tech boom, even the most timid American investors were throwing money into the market

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like drunken sailors. When the markets deliver the opposite experience, we look at stocks and see nothing but risk.

This last piece of the risk tolerance puzzle is, today, sending out alarm bells that are echoing deep into the psyche of American investors. The S&P 500 has just delivered the worst market performance in the month of August since 2001 – which professional investors know is a random event. But now we're in September, that very same month when Lehman Brothers went down and AIG effectively declared bankruptcy back in 2008. It also happens to be the same month that the country experienced the shock of 9/11 – which, among a lot of other things, sent the global investment markets reeling.

And September is followed by another scary month. Chances are you don't remember it personally, but the 1929 crash occurred in October – and October was also the month of the Black Monday free-fall in 1987.

So we had a dismal August that gave back the gains that the market had created in the first seven months of the year, and we're entering that scary month that many people associate with recent financial disaster. Logical minds know that a reprise of 2008 is unlikely, and if you've been reading the papers, you know that corporate profits have been going through the roof in the American economy. But the emotional part of your mind looks at the market and conjures up every negative statistic, and sees far more potential risk than reward, and experiences fear even as you strap on your parachute at 15,000 feet and give an enthusiastic high-five to the instructor who is looking a little nervous.

It's hard to reassure your clients when you don't know whether the month of September will bring the markets back into positive territory or not. But you CAN communicate something more fundamental: if we try to invest based on what the markets did recently, where does that lead us? August was negative, so get out in September. September is positive, so get back in. October is down; get back out; November is up, so you get back in – and over time, whether you follow this formula for months or years, or through bear and bull markets, you end up in the market when you would have preferred to be out, and out when it was better to be in.

The hardest thing to do as a professional – and maybe the only truly important role of a professional investor – is to refuse to let greed OR fear dictate your portfolio composition. In the long run, that gives you an edge on others who are responding without understanding what, exactly, is driving them to the sidelines whenever stocks go on sale.

Bob Veres publishes Inside Information – a monthly service that reliably helps advisors become more effective, efficient and successful. To obtain the discounted price, go to http://www.bobveres.com, click on the "order" tab at the top, and then input the discount code "55DF" when prompted.

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