How to Psychologically Prepare Clients for Bear Markets

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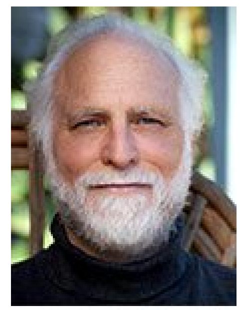
Bob Veres

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 its 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 your portfolio design work or your research into the actual investments that you recommend. You make money for your 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 investors in seven different investment categories through the middle of 2013, its researchers found 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: U.S. 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 investors in mutual funds overall got a total of 1.68% a year, while the funds they invested in were returning 3.18%.

The best-known survey, the Dalbar Quantitative Analysis of Investor Behavior (QAIB for short) recently calculated a 20-year investor return of 5.02% vs. 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 your asset allocation, asset selection, tactical shifts or rebalancing activities that can reliably add this much return to your clients' bottom lines?

The question, then, is *how* do you prepare clients so they won't give in to the herding instinct and sell out at the wrong time? A bear market can be defined as a decline of 20% or more, or as a time period when a high percentage of investors are pessimistic about the investment markets – and, of course, your clients contribute to that group psychology.

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

Tale of three brains

Haman, a former psychologist with a graduate degree in theology, says that it helps to understand that you, your clients and all the 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; (3) below that at the top of the spine, a cluster of neurons which, together, possess roughly the thinking power of a lizard.

Nashville, TN-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 prioritization 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 your clients' brains are many times more powerful than their 'slow-thinking' rational mind, they clamor with overwhelming force for your clients to take action to fix the problem. "Bear markets tap into the instinctive ‚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.

What solutions?

Practice the next downturn

One time-tested strategy is to desensitize your 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.

"Advisors should have the humility to tell their clients that they simply cannot predict the future and that they 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 it happens, the markets delivered the perfect example of a fake-out at the start of the year, which you can use as a kind of Exhibit A for what you're talking about. 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 dollar was squelching exports, we experienced 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 your 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 [you can 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%?

And make sure clients are aware that *you're* aware of the dangers their lower brains are facing. "As soon as volatility increases, and especially when losses are mounting," Haman suggests, "reach out with thoughtful commentary about what is happening and why, and guidance for the best way to respond."

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

Okay; the first exercise is for beginners, and a few of you have already started having conversations along these lines. Many advisors proudly told me that, due to their careful preparation, they never got a client call during the disastrous first couple of weeks of 2016.

But 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 neutralize 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 realize that the lower parts of the brain have no command of language."

Have you ever tried to have a conversation with an alligator?

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 that you shouldn't give advice or preach the wisdom of the markets – at least, not right away.

"The worst thing an advisor can do is criticize or disregard the strong feelings the client is having," Haman says. Advisors 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 that the advisor does not understand the gravity of the current situation."

Minimizing or diminishing the impact of the event will only alienate the client at precisely the time when the advisor should be building a bridge. 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 your clients start to become rational and able to communicate on a logical level. "If the advisor will string together several such questions in a step-by-step fashion and will 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, the advisor can 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, "the advisor can 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 separate yourself from the panicked herd mentality. Many times, advisors assume they are immune from fear, but if you think back to how you were feeling in the late Fall of 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 your clients.

Maybe your clients will experience 30% to 40% drops in the value of their portfolios as a result of your efforts, when their instinct was to get out when the portfolio was down 'only' 10%. Haman and Klontz both recommend that you avoid recrimination, or believing with the dubious benefit of hindsight that you could have known what was coming in advance.

If you could truly predict the future, you could add thousands of percent to your clients' portfolio returns. 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, the advisor, 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 between clients and their advisors, and the prudent advisor understands the importance of this dynamic as well."

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