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Coaching to Mitigate Panic

Helping clients manage emotions has a significant impact on portfolio returns.

TOOLS

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What is the value of behavioral coaching? The frequently cited "Advisor's Alpha" study by Vanguard estimates that the annual financial value of behavioral coaching for investors is 150 basis points, based on observed investor behavior with target-date funds.[1] In a recent *Journal of Financial Planning* article, I take a deeper dive into the dollars and cents of behavioral coaching—and how it can help investors succeed.[2] Here, we'll jump straight into the results and what they mean.

Why Do We Need Behavioral Coaching?

One of the benefits is obvious: It can mitigate panic during market downturns. Advisors can help clients avoid selling at the wrong time and missing a subsequent upswing. Beyond the obvious answer, behavioral tools to help investors avoid panic are needed because the industry's current approach of matching investors to investments is well-intentioned but incomplete. We are putting two competing demands on the investing process by trying to select investments that will both a) deliver the returns that investors need to reach their goals and b) avoid volatility that might lead them to abandon their investment plan.

To manage these competing demands, advisors generally apply one, or both, of two approaches: a risk-capacity approach that focuses on goals and generating the required returns and a risk-preference approach that seeks to decrease volatility exposure for those who are deemed more sensitive to it. In isolation or in combination, these two approaches may fail both to help clients reach their goals and to forestall their panic.

For many investors, these two demands simply cannot be met at the same time using asset-allocation alone. The returns they need to reach their goals may require risk exposures that they would prefer not to have. Mixing the two approaches—for example, by calculating a stock/bond glide path based on time horizon and then shifting it up or down based on risk preferences—seems reasonable in principle. Unfortunately, splitting the difference may mean fulfilling each need less well. A better approach is to address the two issues using tools designed for each purpose.

Divide and Conquer With New Behavioral Tools

Asset allocation is an appropriate and powerful tool, but on its own, it may not be enough to help investors handle risk. Behavioral tools—that help investors prepare for and respond to volatility when it comes—are more appropriate. The tools can address the discomfort directly, or provide other ways to manage volatility. Here are some potential techniques from the literature:

- To reduce panic selling, the financial-services industry can better package long-term investments as "set it and forget it" tools, learning from the outcomes that target-date funds have achieved.[3]
- To alleviate loss aversion, investors and their advisors can avoid frequent price updates.[4]
- To avoid predictable mistakes, the industry can educate investors on common issues like confirmation bias and the availability heuristic.[5]

Measuring the Impact

To better quantify the value of using behavioral tools alongside asset allocation, my paper presents results from a novel simulation model of investor behavior. In short, the model simulates various scenarios under which investors might panic and determines the effect on long-term outcomes.

The model demonstrates how investor panic can result in a loss of between 8% and 15% of assets over a 10-year period when standard approaches are used—such as risk-capacity-based asset allocations and risk-preference-adjusted glide paths. The results are robust to a range of model specifications and assumptions: No matter how you slice it, panic can be highly destructive.

By also incorporating behavioral tools (alongside risk-capacity asset allocations), investors can receive a net increase of 17% to 23% in assets over 10 years, or roughly 170 to 225 basis points per year in returns. Some of that return comes from avoiding panic, supporting the analyses by Vanguard and others. The rest comes from freeing up asset allocation to better serve the financial needs of investors and removing the tension between the two competing demands outlined above: achieving an investor's financial goals while avoiding uncomfortable volatility.

Advisors know that investors struggle during times of volatility. This paper helps point the industry toward a new set of behavioral tools to ease the struggle and help investors reach their goals. M

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