Managing Behavioral Responses to Investment Downturns

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What is the greatest risk to a family’s wealth and future purchasing power when a crisis hits the markets? Why do families reflexively destroy capital by immortalizing capital losses and then allowing their risk taking abilities to atrophy? Destruction of wealth seems hard-wired into the investment-decision-making DNA of many investors when severe and protracted downturns strike their portfolios. In this session, we will discuss the Whys and the How Tos of extreme-event decision making for families and their advisors as we explore what it means to say that the greatest risk to family wealth is owning the wrong portfolio!
Destruction of wealth does seem hard-wired into the investment-decision-making DNA of many investors when severe and protracted downturns strike their portfolios. For a variety of reasons, investors with “overly” risky portfolios proceed through a sequence of overconfidence and herding to anxiety and then full-blown panic as they race to immortalize capital loss, often from the peak of a crisis until its subsequent low point. Compounding that first round of wealth destruction is a period of risk atrophy and inaction during which investors watch the portfolios they used to own rebound significantly. In psychological terms, their behaviors center ultimately on flight and freeze, while the financial impact of this loss and inaction cycle is a substantial reduction in wealth and relative purchasing power.
Bad Choices Entail Bad Consequences

• The issue in crises and extreme events is making wise choices
• Traditional decision approaches assume investors can subjectively assess the impact and likelihood of choices and rank them accordingly
• In fact, emotional reactions in crisis periods often conflict with these “rational” assessments and drive destructive behaviors

Real outcomes result from choices taken during crises and extreme events. Real family wealth is destroyed and purchasing power is impaired. As a result, we know that bad choices do entail bad consequences. Normative remedies are needed and must derive from a clear understanding of how judgments are formed and how decisions are actually made. The traditional approach to investment decision making involves a rational calculus that is often characterized as cognitive and consequentialist. *Consequentialist* implies that decisions are based on an assessment of the consequences of possible outcomes, including the impact of anticipated emotions in the future. What the traditional approach fails to consider, however, are the immediate – and often visceral -- feelings associated with a decision itself. Because of this omission, traditional decision making is also referred to as *cognitive*.
Based on what we witness as investors melt-down in crisis periods, it is reasonable to conclude that emotions inform decision making and that immediate “emotional responses to risky decision situations … often diverge from cognitive evaluations.” (Loewenstein). In other words, emotion-driven behaviors displace *Homo economicus* when push comes to shove in real markets. Understanding the dynamic interplay of cognitive and emotional factors, and in particular distinguishing between anticipated emotions and anticipatory emotions, is critical to understanding and managing the role of feelings on risk assessment and decision making.
To better understand practical wealth destruction, it’s important to retrace the steps that often lead to panicked selling. In the pre-crisis phase, we encounter surging markets and an over-confident investor in the company of a growing and influential group of similarly over-confident investors. The cartoons (Scientific American) depict two important cognitive illusions that powerfully influence consequentialist- and feelings-based inputs during this phase. Excessive conviction follows from a propensity to overrate our skill. Like the children in Lake Wobegone, we sincerely believe we are always above average and selectively emphasize information that confirms our inflated view when forming judgments and views (confirmation bias). As we and others converge to similarly satisfying conclusions, a herd forms that negatively reinforces our tendency to disproportionately weight recent positive information in projecting future outcomes (availability bias). Together, these illusions color our analysis and emotions.
At some point in the progress of bubbles, prices reach unsustainable levels and cracks appear in the positive data stream. Availability bias flips over as immediate data begins to point to falling prices and the race is on. From a decision perspective, these early fissures induce anxiety as our investor begins to feel vulnerable to the environment and to others in the herd. Fear of loss of control and a sense of being overwhelmed makes us anxious. The importance of wealth to most investors only serves to amplify this anxiety until the sustained sense of vulnerability becomes acute, danger seems imminent, and anxiety transitions to full-fledged panic. Triggered by a unity of correlation across risky assets, our seemingly entrapped investor shouts “SELL, SELL.”
Reducing Vulnerability

- Partition strategies into pre-crisis, crisis, and post-crisis periods
- Engage in purposeful study, introspection, and historical simulation
- Clarify roles and responsibilities – particularly with non-family advisors -- through policy statements and operating manuals
- Exploit behavioral opportunities such as framing, anchoring, and counterfactual thinking to force skepticism and self-awareness

Given the cognitive and behavioral insights discussed so far, we know that investors are vulnerable to a wide range of challenges in virtually every aspect of investment decision making. Accordingly, it is important that investors and their advisors implement effective programs for extreme event preparation, response, and recovery. Any such program must engage investors and advisors in regular, ongoing, and purposeful study of the cognitive- and feelings-based patterns involved in prior crises and must tailor and exploit behavioral opportunities such as framing, anchoring, and counterfactual thinking to force skepticism and self-awareness. It must also formalize regular actions by implementing specific policies, procedures, and checklists that anticipate and mitigate the panic that builds through a full crisis cycle.
The Boy Scouts have it right about being prepared ... always swim with a buddy who watches your back and holds you to account for the behavioral and cognitive factors at play in your investment thinking and decision making. The great enemy of successful investing – especially crisis investing – is a reliance on intuition and feelings that are not validated by rigorous analysis and empirical testing. Without an honest and persistent devil’s advocate, we inevitably rely on heuristics that worked well when we were attacked by now-extinct wild beasts but are inadequate when we are making judgments in highly probabilistic and competitive markets subject to animal spirits!
• The Final Jeopardy Category is “Egregious Investing Errors”
• “Owning this maximizes the likelihood of avoiding wealth destruction during a severe market crisis”
• My Final Jeopardy Wager is “My Family’s Wealth”
• What is “The Right Portfolio,” Alex?
• That is the correct answer!

To manage through crisis periods and extreme events, we propose designing and implementing programs that function in some sense as a vaccine or antidote to the many behavioral and cognitive challenges bestowed on us by Mother Nature and a capitalist political economy. Having such a program is necessary to mitigate the risk of panic and wealth destruction, but it is insufficient. The true test of effective extreme event preparation is choosing The Right Portfolio well before any crisis or extreme event occurs. To do that requires understanding the trigger that transitions investors from anxiety to panic. That trigger is the unity of correlations that occurs swiftly and completely when all risky assets plummet in a market crash. The perception that the market for risky assets, and hence all family wealth, is going to zero ignites panic. The remedy that forestalls a shift in the emotional balance of power, however, is owning enough of the Flight-to-Quality Asset in the family’s portfolio. How much is entirely subjective in that there needs to be enough impact on portfolio performance that the investor perceives the existence and support of this negatively correlated asset in the emotional battle against panic that is measured by the family P&L. A positive position with imperceptible performance impact won’t get the job done. Heuristics for setting the amount will be discussed during the session.


Jim Foster is a Managing Director of Greycourt & Co., Inc. Prior to joining Greycourt, he was an Executive Vice President and Head of Distribution for Schroder Investment Management North America in New York. Before that, he was a Senior Vice President with Mellon Financial Corporation working across institutional investment management and consulting. Prior to joining Mellon, he was a Vice President with J.P. Morgan where he helped establish the mortgage-backed securities department and traded and made markets in mortgage-backed securities. While at Morgan, he worked in Global Derivatives in the Equity Derivatives Group and was responsible for private structures created primarily for U.S. pension accounts and investment managers. He also taught fixed-income securities markets, valuation, and portfolio management techniques for several years as an Adjunct Assistant Professor of Finance in the Stern School of Business at New York University. Mr. Foster is a graduate of the University of Michigan and Carnegie-Mellon University and currently chairs the Board of Visitors for the University of Michigan’s Institute for the Humanities.