USI ADVISORS, INC.

Fear and Greed-Driven Biases in COVID-19

Introduction

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The global pandemic of COVID-19 has created dramatic and unprecedented challenges on the health care system, economic activity, and job market. With excessive stock price volatility and uncertainty on the horizon, investors may be experiencing a range of intense emotions, resulting in irrational behavior and cognitive biases, which could potentially put their long-term retirement savings in jeopardy. It is difficult for the average retirement plan participant to completely set aside their emotions and fear of market losses when making investment decisions in their retirement accounts. However, it is important for plan sponsors to gain a better understanding of the psychological drivers behind this behavior and be able to design effective communications to safeguard against potentially imprudent or irrational decisions.

Behavioral finance attempts to explain how individuals make investment decisions amidst certain markets in order to improve economic results. This theory acknowledges that people are not rational decision makers, employing mental shortcuts to make their decisions that may result in suboptimal outcomes. During the recent market turbulence driven by the rapid spread of coronavirus around the world, some participants had trouble maintaining their contribution rates or staying the course. While multiple biases are identified in the field of behavioral finance, some common cognitive biases observed during the COVID-induced global crisis are as follows:

Loss-aversion Bias

Loss aversion is a cognitive bias where the investor's desire to avoid losses is nearly twice as great as the pleasure of investment gains. In other words, participants may experience the pain of loss in their 401(k) plan to a greater extent than an equivalent positive return. For example, when the S&P 500 tumbled 34% by late March from its record high a month prior, the fastest and deepest selloff in U.S. stock market history, investors likely felt the sting of the losses far more deeply than they might rejoice at a comparable gain. Driven by fear of losing their retirement savings, some participants shifted their 401(k) portfolios to less risky assets such as money market or stable value after a significant market drawdown, locking in their losses and looking to re-enter when the market recovers. Plan sponsors can target these participants with communication pieces around the power of staying the course and showing a few examples of historical bear markets and subsequent market gains, as well as examples of missing out on the best days in the equity market.

Home-Country Bias

People often concentrate their portfolios in favor of domestic and local securities at the expense of global diversification, a phenomenon called home-country bias. This bias reflects investors' preference for domestic brands, creating a desire to overweight their country's securities within their portfolios. While U.S. stocks account for around 55% of the global equity market, many U.S. investors tend to allocate over 70% of their assets to domestic equities. In fact, according to the Plan Sponsor Council of America, the average number of actively managed domestic equity funds in 401(k) plans is 5.9, capturing 18.6% of plan assets, whereas the average number of actively managed international and global equity fund options is 1.9, with a meager allocation of 3.8% of plan assets. Some of the home-country bias has been magnified in recent years from participants' tendency to chase performance, which has been skewed toward a stronger U.S. market. Your recordkeeping partners have education pieces around the power of diversification and the importance of having exposures to different investment styles, market capitalizations, and geographic regions as market leadership changes over time.

Herding Bias

Herding is a fear-driven bias, which is represented by the investors' tendency to follow the crowd. When faced with market volatility, participants may ignore their long-term retirement goals, risk tolerance, and time horizon and instead they tend to copy what other people are doing. Many investors are overreacting during times of uncertainty, with the crowd usually running in the wrong direction. In the case of the current market crisis, some frightened investors liquidated their long-term stock positions as if in a herd, following others that had moved their assets into the perceived safety of cash. Plan participants may benefit from communication pieces, emphasizing the importance of developing and maintaining a long-term investment plan based on their own time horizon and risk tolerance rather than following the crowd.

Confirmation Bias

Confirmation bias is our tendency to search for, find, and interpret information that supports our opinion, while ignoring information that contradicts our beliefs. Some people try to keep up with the latest news and use information that corresponds to their own opinion, which can lead to suboptimal outcomes. As the novel coronavirus grew into a global pandemic, consumers around the world stockpiled goods like hand sanitizer, toilet paper, and canned foods. With empty store shelves amid the coronavirus-induced panic buying, some investors felt that their worst fears were confirmed, liquidating their assets, rather than maintaining a long-term strategic outlook. Participants with long-term time horizons should maintain a long-term outlook on equity markets rather than make impulsive temptation to time the market.

Overconfidence

Overconfidence is a greed-driven bias, which is illustrated by investors' tendency to consider themselves better than average at making decisions. Overconfident investors may overestimate their abilities and investment knowledge, which may lead to inappropriate risk taking and excessive trading. The recent equity rally from the March 23rd lows illustrates the overconfidence bias effect at work. After enjoying more than a decade-long bull market, some Baby Boomers increased their equity exposure immediately following the market downturn amid hopes that stock market will only head higher over time again. However, becoming overexposed to risk, when markets are still choppy, may lead to poor portfolio performance.

During periods of extreme volatility, when stock prices are bouncing up and down based on a rapidly shifting mix of fear and greed-driven biases, emotions may cloud investor's judgement. Faced with uncertainty, some participants may be tempted to take control in a way that is likely to be detrimental to their retirement savings. When the market is driven by emotions and behavioral finance biases, it is imperative to remain focused on the long-term and keep your long-term asset allocation plan in mind. Although inaction could seem like a counterintuitive strategy, avoiding rash decisions based on emotions and staying invested could lead to a better retirement outcome.