The Psychology of the Client Sell-Off

By Dr. Frank Murtha

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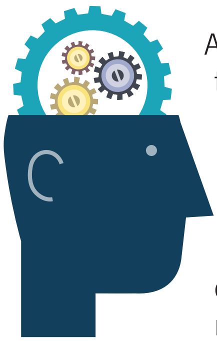

At times of great uncertainty, volatility, and perceived risk in the stock markets, many investors will want to sell. This may be one of those times.

The decision may represent an important crossroads for the client and for the financial advisor as well. Extreme selling (i.e., panic) can harm a client's well-being. Facilitating such actions may be considered a violation of the FA's responsibility as a fiduciary. People's opinions differ on this issue. It is not within the scope of this article to argue one side or the other. What we do offer are insights on different ways to approach clients who are inclined to sell at least part of their equity portfolio and raise cash during market crises.

Before They Decide to Sell Off: Three Considerations

1. Ultimately, you cannot control what your clients do. It is important to recognize and accept this. You can influence them, but you cannot control them, nor should you. This self-admission is important not only to frame the situation accurately, but to relieve any self-imposed pressure. You provide wisdom, guidance and support, but the money belongs to the client, and he/she will make the decisions.

2. Discourage binary thinking if possible. Whether in poker games, diets or investing, the notion of binary thinking (i.e., I'm "all in" or "all out") is usually an unhealthy and destructive framework in which to operate. This "thought trap" can increase the stakes of the decisions, raising their emotional impact and the consequences of being wrong. Seeing shades of gray and taking incremental steps often promotes emotional stability.

3. Discourage perfectionism. "Buy low and sell high" is a worthy maxim. "Buy at the bottom and sell at the peak" is not. Trying to "thread the needle" by calling tops and bottoms is likely to be a losing game. What's more, it can prevent prudent, incremental moves that restore a sense of balance. Establish the expectation that your calls won't correspond optimally with market tops/bottoms, and that *they don't need* to in order to be helpful. As the old saying goes, "Do not let the perfect become the enemy of the good."

If They Decide to Sell

The first question to ask the client is, *"Do you intend to get back in?"* If the answer is yes, even a vague version of yes, then there is planning to do. If the answer is no, it is time to have a deeper conversation about the implications, perhaps tell them it is time to revisit their long-term goals or help transition them to another advisor if you choose not to help implement their decision.

If the answer to the above question is affirmative, a useful next sentence is: *"Then let's talk about how and when to re-enter the market because one of the biggest mistakes investors make is not having a plan."*

Selling during panicky times can be easy. What comes next is likely to be much more difficult. It is vital that clients understand and even anticipate this.

To help guide them through the process, try this thought experiment:

- Imagine after you sell your equity holdings the market quickly drops an additional 10%. How would you feel? The chances are you would feel glad you got out. You avoided further losses. ***But would you want to get back in?*** Presumably you sold because you feared heavy losses, not to protect against a short, 10% move. And if that happened, the market would have confirmed your thesis, validating your fears. The psychological pressure would be to *stay out*.

- Now imagine after you sell your equity holdings the market rises 10%. How would you feel? You probably would feel a little like kicking yourself. ***But would you want to get back in?*** Doing so at that point may feel like losing money, which is painful. Compounding that pain is that you may *feel* responsible for bringing the loss on yourself; this is an emotion we call “regret.” There is a way out of this predicament, however; and the *way out is to stay out*. We can avoid that pain of regret by refusing to buy back in, waiting instead for the market to drift lower again. This is a psychological trap that has caused many investors to lose years’ worth of returns all to avoid a manageable, short-term loss.

Part of what makes re-entering higher markets difficult *after* we have sold is how we may feel about *ourselves*. Getting back in may feel like admitting a mistake—which is challenging to many people. Before people invest, they have to feel OK about themselves for doing it. (NOTE: The need for self-approval, covered in the *Investor Hierarchy of Needs*, available from Brandes, is one of the most underappreciated drivers of investor behavior.)

Advisors may wish to walk their clients through these separate scenarios and make it clear that they will likely be facing these psychological obstacles to reentry. The move back in should be managed to avoid the binary thinking and perfectionism mentioned earlier.

Successful plans typically rely on scheduling and structure. Look to create an incremental series of moves to reengage, based either in terms of time elapsed (e.g., weeks, months) or on percentage moves (e.g., 5%, 10%, 20% etc.), whether that’s market moves or fluctuations in the client’s asset allocation across stocks, bonds, cash and/or other assets.

A critical element of the process is establishing commitment on the part of the client. Making a plan is one thing, but executing that plan in a challenging emotional environment when you really don’t want to is another.

Contact us with any questions or for additional tools and tactics designed to help manage your clients’ behavior. We know this is a challenging environment. Brandes remains here to help.

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