BEHAVIORAL FINANCE AND THE CORONAVIRUS SCARE

March 10, 2020

With the price action on March 9th, 2020, many investors are concerned about the market entering a "bear market" (20% or greater loss). The market is off about 19% from its peak on February 19th, 2020. To provide some perspective, in 2019, there wasn't a single daily loss for the S&P 500 in excess of 3%. Over the past ten trading sessions, there have been losses of -3.4%, -3.0%, -4.6%, -3.4% and today down nearly 8%. And during the past two weeks, the S&P 500 rose close to 5% and more than 4% in a single day. This means 7 out of the past 11 trading sessions saw losses or gains in excess of 3%. Much of the volatility is attributable to behavioral impacts; with the impact of coronavirus difficult to quantify, many are investing based on emotion and gut feel. In addition, this volatility is wreaking havoc on the psychology of market participants. The purpose of this piece is to explain why this is happening and add perspective on these market movements – so that investors can remain calm, avoid mistakes, and even take advantage of any panic in the marketplace.

Why Investors are Panicking: A Macroeconomic Behavioral Perspective

I wrote the book "Behavioral Finance and Wealth Management" in the wake of the popping of the 2000 stock market bubble. Since then, we have been through numerous bouts of volatility, including the GFC in 2008 and near bear market in 2018. Looking longer-term, the past 20 years have seen 10 market corrections (down 10% or more). Of these corrections, only two have become bear markets – with the brief correction in Q4 of 2018 almost making it to 20% down.

Start date	Duration	High	Low	Change
7/17/1998	45 days	1186.75	957.28	-19.3%
7/16/1999	91	1418.78	1247.41	-12.1%
3/24/2000	**929**	**1527.46**	**776.76**	**-49.1%**
11/27/2002	104	938.87	800.73	-14.7%
10/9/2007	**517**	**1565.15**	**676.53**	**-56.8%**
4/23/2010	70	1217.28	1022.58	-16.0%
4/29/2011	157	1363.61	1099.23	-19.4%
5/21/2015	96	2130.82	1867.61	-12.4%
11/3/2015	100	2109.79	1829.08	-13.3%
1/26/2018	13	2872.87	2581	-10.2%
9/20/2018	95	2930.75	2351.1	-19.8%

Source: Yardeni Research

Investor biases, which I review in my books and articles, exist in some form or another within all investors and become amplified during market declines such as the one happening now in March 2020. People tend to copy the behavior of others when they are faced with uncertain prospects and the stock market provides a great example. In fact, the behavior of crowds is often what causes large amounts of volatility in the stock markets – both on the upside and the downside – because everyone wants to get in or out at the same time. During times like the tech stock bubble of the late 1990's or the real estate bubble of the 2000's, investors followed the behavior of other people they believe to be "industry experts" or people deemed prescient by the financial media. This is called *herding*. And this is what is happening now. In these cases, herding behavior caused massive inflows and outflows into a particular asset class and in effect a tsunami was created. Herding is a reactive phenomenon (i.e., not something that people contemplate to any great degree). It just happens. When investors herd, they override their common sense and just want to "get in" or "get out" so they don't get left behind. There is a term that has been developed recently called "FOMO" – fear of missing out. This is classic herding behavior. As others make money (bull market) or lose money (bear market), the investors who are *not* participating follow the crowd because they feel their economic status will fall relative to those who *are* participating. This behavior causes even more of the same behavior and bubbles begin to form causing irrational asset prices.

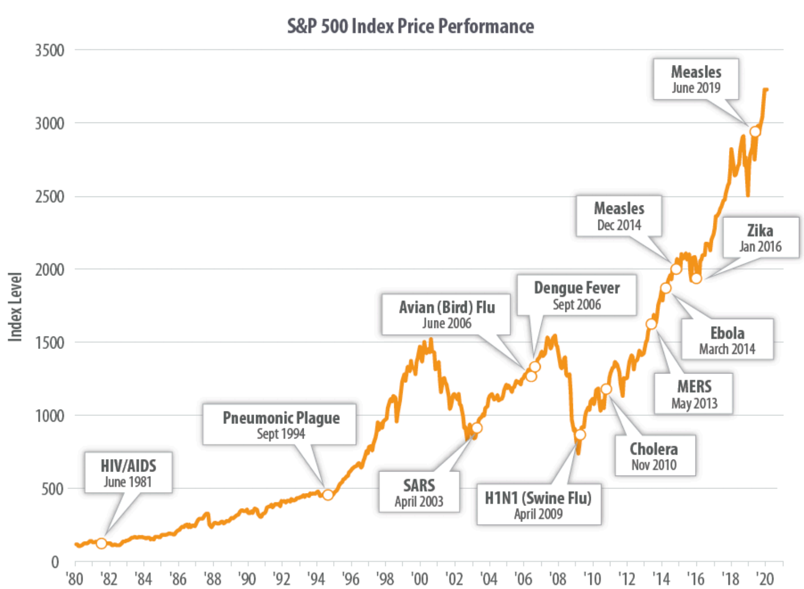
Explaining Individual Investor Decision Making During Market Meltdowns: Loss and Regret Aversion

Daniel Kahneman and Amos Tversky (K&T) revolutionized our understanding of individual economic decision making. Importantly, K&T discovered that most people are loss averse. They estimated that avoiding loss is approximately two times as powerful as winning. More practically, it would take a win of $50 to compensate for losing $25. Therefore, most people are willing to sacrifice gain to avoid loss and this concept is known as *loss aversion*. Loss aversion compounds when stock markets are tanking. This concept explains why stocks have such a higher long-term return than bonds. Because stocks are risky, people overpay for bonds (i.e., insurance) because they fear the risk of losses in stocks. With the market down nearly 20% and the 10-year US Treasury below 1%, this is key evidence of this concept. In general, people prefer certainty to uncertainty even if the value of the certain choice is less than the value of the uncertain choice. K&T demonstrated that people are willing to make a much larger sacrifice for certain choices versus rational economists who believe that people are willing to make only small sacrifices in exchange for certainty.

Regret aversion is an emotional bias in which people tend to avoid making decisions that will result in action out of fear that the decision will turn out poorly. Simply put, people try to avoid the pain of regret associated with bad decisions. Regret aversion can drive some investors to panic sell at exactly the wrong time; they fear the market will continue its slide and hit the panic sell button when markets have recently generated sharp losses. When deciding, for example, whether to sell into a market meltdown, our instincts tell us that we might have serious regret if the market slides further. However, when looking at the long run, stocks have *always* recovered. Panic selling is *almost always* the wrong course of action.

Keeping Things in Perspective: Epidemics and Stock Market Performance

There are many factors that can impact stock market returns, but one concern of investors today is how the stock market will be impacted by a major epidemic or outbreak. Below we look at the historical performance of the S&P 500 Index during several epidemics over the past 40 years. In sum, this too shall pass. Looking at the market's resiliency through numerous major epidemics gives us perspective on the benefits of investing for the long-term.



Epidemic	Date	S&P 500 6-Month % Change	S&P 500 12-Month % Change
HIV/AIDS	June 1981	-6.6%	-16.5%
Pneumonic Plague	Sept 1994	8.2%	26.3%
SARS	April 2003	14.6%	20.8%
Avian (Bird) Flu	June 2006	11.7%	18.4%
Dengue Fever	Sept 2006	6.4%	14.3%
H1N1 (Swine Flu)	April 2009	18.7%	36.0%
Cholera	Nov 2010	13.9%	5.6%
MERS	May 2013	10.7%	18.0%
Ebola	March 2014	5.3%	10.4%
Measles	Dec 2014	0.2%	-0.7%
Zika	Jan 2016	12.0%	17.5%
Measles	June 2019	9.8%	N/A*
Average Price Return		8.8%	13.6%

Observations

- 6-month change of the S&P 500 Index following the start of the epidemic was positive in 11 of the 12 cases, with an average price return of 8.8%.
- 12-month change of the S&P 500 Index following the start of the epidemic was positive in 9 of the 11 cases*, with an average price return of 13.6%.

Source: Bloomberg, as of 2/24/20. Month end numbers were used for the 6- and 12-month % change. *12-month data is not available for the June 2019 measles. **Past performance is no guarantee of future results.**

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Returns are based on price only and do not include dividends. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future.

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Lastly: Markets Will Likely Recover Quickly

If history is any guide, after the coronavirus scare is over, we should see a relatively quick recovery in the stock market. At today's writing, there are numerous things the Federal Government plans to do such as fiscal stimulus. In addition, there is a reasonably good chance that the Federal Reserve cuts rates again later in March 2020.

Conclusion

Investors need to be aware of their behavioral biases and attempt to lessen them during both strong bull markets and panics. During the recent bull market run, some investors fell prey to biases like overconfidence, optimism, and status quo and failed to rebalance even though their equity allocations had become overweight compared to their strategic policies. On the other hand, during the recent selloff, in addition to loss and regret aversion, some have been susceptible to availability (bad news) and recency bias.

It is easy to have a knee jerk reaction to market losses. We at Sunpointe work with our clients to mitigate behavioral biases during the investment process. In short, we ensure that our clients focus on rebalancing and making sure that their long-term strategic allocations are properly aligned with their goals and risk tolerance. While short-term volatility may be uncomfortable, it should not cause us to deviate from long-term strategic plans.

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