Investment Management

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Insights from Omar Aguilar

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Perspective on global equity markets through a behavioral finance lens

Loss aversion and confirmation bias: Emotion in motion

December 2020

Unprecedented and uncertain, two words that aptly describe 2020, are also two conditions that can activate behavioral biases. Investors have been swamped by a confluence of two distinct biases during the COVID-19 crisis. Loss aversion, a bias with both cognitive and emotional overtones, is the preference for avoiding losses over achieving equivalent gains. Confirmation bias, from the brain's rational side, is the tendency to seek information that supports our pre-existing beliefs and ignores contradictory information. This edition of our recurring behavioral finance insights examines loss aversion and confirmation bias in the context of market activity during the global pandemic. We look at how these biases influenced Millennials and Baby Boomers in particular and share ideas that may help advisors achieve more successful long-term outcomes for their clients.

Riding the behavioral waves

Investors' reactions during the first six months of the current health crisis played out in the three waves, starting with loss aversion. In late February and early March, uncertainty and confusion about COVID-19 spread almost as fast as the virus itself. With a resolution to the crisis on an unknowable timeline, many frightened investors sold their assets as if in a herd—a frequent loss aversion response to uncertainty. Studies suggest that the desire to avoid losses is nearly twice as great as the hope of earning a reward, making loss aversion a powerful motivator, and particularly prevalent when market volatility spikes.

Key takeaways

- The market's reaction to the COVID-19 crisis stirred emotional and cognitive behavioral biases.
- Uncertainty fueled loss aversion behavior as COVID-19 became a pandemic, helping to send stocks into a tailspin.
- Confirmation bias may have accelerated the steep equity market selloff but may have helped fuel the sharp rebound as well.
- Baby Boomers were likely affected by both loss aversion and the confirmation bias, as were Millennials, who may have been slow to return to stocks.

Loss aversion and other fear-driven biases

After the emotional opening to the health crisis, confirmation bias took over in the next market wave as investors sought to manage uncertainty as equities spiraled lower and the global economy weathered the fallout from COVID-19. Just as missing toilet paper from store shelves sparked a confirmation bias effect among consumers, the stock market sell-off activated a confirmation bias feedback loop for many investors, fueling additional liquidations that accelerated the decline. By late March, stocks had fallen more than 20% from their early year highs—as the chart below demonstrates—awakening a bear market.

Unprecedented global response

As the outbreak worsened, responses by governments around the world were unprecedented. Business shutdowns, travel restrictions, and record fiscal and monetary stimulus to support workers were all part of the collective relief package. Many of the stimulative benefits from this package emerged in the third wave of the health crisis: some regions eased socially imposed restrictions and financial markets started the long road toward recovery. Many people began to view the pandemic like a natural disaster, forecasting a definitive end to the crisis, and pricing in expectations accordingly. People also became more accustomed to living amid COVID-19, as social distancing, wearing a mask, and working and schooling from home became increasingly commonplace. And, as occasional good news supported a more positive outlook, confirmation bias once again played a role in shaping market behavior. Equities surged in anticipation of economic improvement, creating what some perceived as a stark dichotomy between soaring stock prices and pervasive pandemic uncertainty.

Tackling loss aversion bias

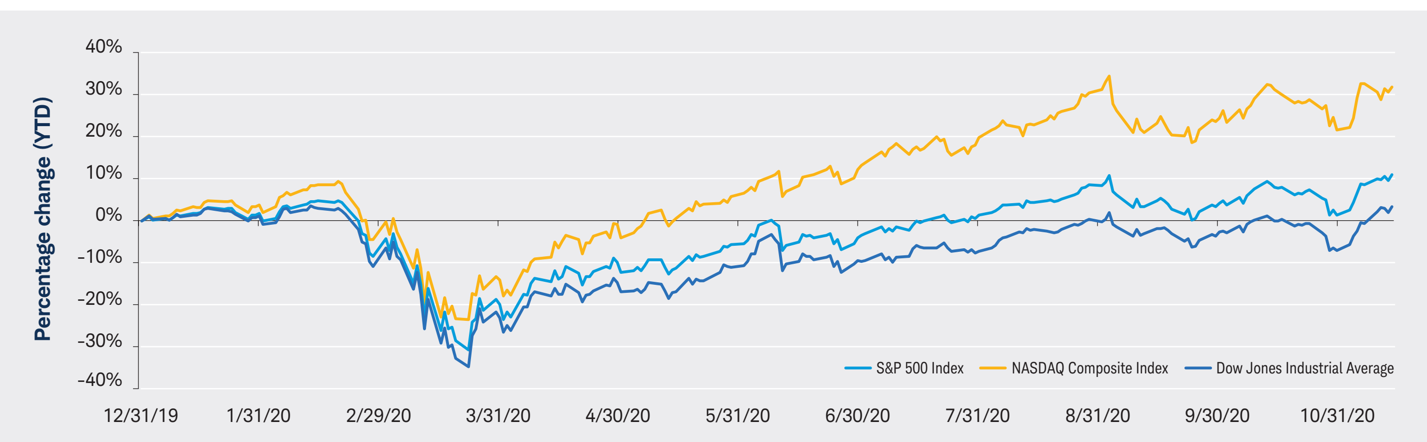
In an unprecedented and uncertain climate, open communication and objective trading rules may help clients maintain an objective viewpoint on reality. To help clients suffering from loss aversion, consider establishing concrete rules around buying, selling, and rebalancing. A lean media diet may also be in order, encouraging clients to limit financial news exposure that often dramatizes the latest developments and market swings, rather than helping investors focus on long-term performance trends.

Identifying and treating confirmation bias

To identify and potentially treat confirmation bias behavior, advisors might start by uncovering their clients' long-held investment beliefs. If necessary, an advisor could then provide more realistic viewpoints to help clients better balance their understanding of an investment opportunity. Objective trading rules often help as well, giving clients a potential means to override their cognitive impulses. For example, news of potentially successful vaccines have led to market euphoria, reflecting a short-term emotional reaction to a one-time event. Instead of reacting to such a development in knee-jerk fashion, investors might be well advised to consider such corresponding market shifts as an opportunity to rebalance while staying focused on their previously identified long-term financial goals.

COVID-19 put investors' emotions in motion

Loss aversion dominated the early downturn, while confirmation bias helpful fuel the rebound.



Sources: Charles Schwab Investment Management; Bloomberg. Data from 12/31/19 to 11/15/20. **Past performance is no guarantee of future results.**

> The COVID-19 health crisis has disproportionately affected older generations, particularly those over 65.

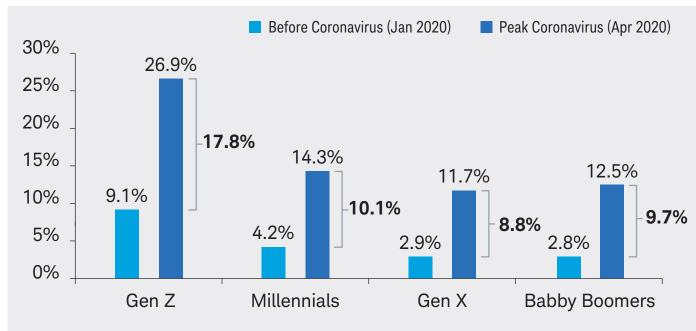
Baby Boomers: Disproportionately affected

The COVID-19 health crisis has disproportionately affected older generations, particularly those over 65, as shown in the bar chart below. Concerns about the virus have been evident among Baby Boomers, and some of this generation's investors sold equities early on amid the pandemic as loss aversion played a role in their investment decisions. While understandable, this behavior was atypical for Baby Boomers, which, as a generation, usually lean much more toward overconfidence. Once equities bounced off bear market lows, some Baby Boomers heavily reinvested in stocks. Confirmation bias probably played a role, boosting confidence on the heels of unprecedented fiscal and monetary stimulus combined with less dire economic news than had been forecasted. With hope for an eventual solution to economic and health challenges awakening, your Baby Boomer clients may see emotional biases return. In particular, herding behavior could lead to momentum investing and overexposure to high-flying stocks, but loss aversion may also start to re-emerge as virus cases spike heading toward 2021.

Millennials: Old fears reawakened

The scarring effects of the Great Recession turned many Millennials against equities until recently, so the COVID-19 meltdown may have reawakened their previously established loss aversion regarding stocks. In addition, Millennials and younger generations have faced the heaviest job losses, as well as unemployment rates well above those facing Gen-Xers and Baby Boomers. This point is captured in the following chart.

Unemployment hit younger generations harder



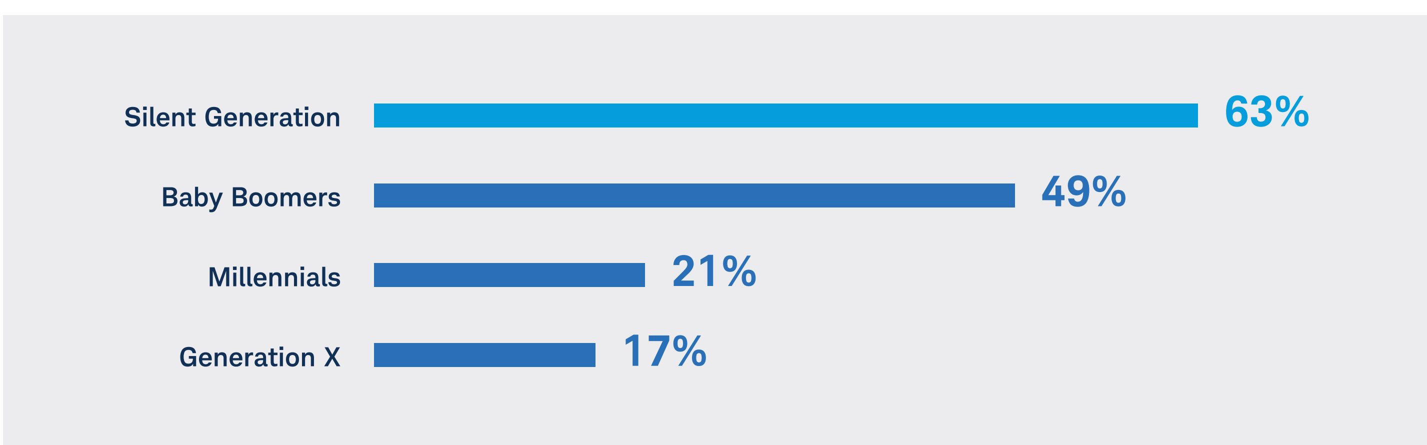
Sources: Charles Schwab Investment Management, Inc.; U.S. Bureau of Labor Statistics. Data not seasonally adjusted.

Rational advice enables better results

With this background in mind, your Millennial clients may need a strong dose of rational advice to counter any deeply embedded investing fears. Offering historical perspectives on the risks and rewards of long-term equity investing may provide some insightful ballast at a critical time.

Older generations tend to be more loss averse

A 2020 survey of advisors by Cerulli Associates showed that older generations were more likely to be influenced by the loss aversion bias.



Sources: Cerulli Associates, "BeFi Barometer 2020." Survey. July 2020.

On the horizon

Market recoveries often occur ahead of economic ones, but today's situation is unprecedented. Many investors seem to be looking down the road in hopes of returning to a pre-pandemic lifestyle. However, if the health crisis worsens heading into the winter months, this may make the stock market much more dependent on further fiscal stimulus, which has remained elusive post-Election Day. Until conditions return to at least a semblance of normalcy, advisors might be well served to focus their clients' attention not on singular events and potential volatility, but on the market's long-term potential.

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About the author

Omar Aguilar is Chief Investment Officer (Passive Equity and Multi-Asset Strategies) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Aguilar joined CSIM in 2011 and is responsible for equity and asset allocation mutual funds, ETFs, and separately managed accounts. Aguilar has more than 20 years of broad investment management experience in the equity markets, including managing index, quantitative equity, asset allocation, and multi-manager strategies. Aguilar received a BS in actuarial sciences and a graduate degree in applied statistics from the Mexico Autonomous Institute of Technology (ITAM). He was a Fulbright scholar at Duke University's Institute of Statistics and Decisions Sciences, where he earned his MS and PhD.

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