Fidelity Viewpoints®: When to Question Your Financial Instincts

TRANSCRIPT

SPEAKERS:

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SEGMENT 1: Make Better Money Decisions

Colleen Rolph: Hello, and thank you for joining us. I'm Colleen Rolph with Fidelity.

Today we're going to be talking about why our brains might be pointing us in the wrong direction when it comes to making the best choices for ourselves and our money and more importantly what we can do about it.

I'm thrilled to be joined by one of my favorite colleagues, Andy Reed. He's a behavioral economist and psychologist who's on our staff here at Fidelity.

Andy, great to have you here.

Andy Reed: Great to be here, Colleen.

COLLEEN: Yes! So I'm sure I'm not alone in thinking what's a PhD in developmental psychology doing at Fidelity? And can you talk just a little bit about, you know, what you do and why it's so relevant now?

ANDY: Sure, it's a great question. So my role here at Fidelity is to help us understand why people make the choices that they do and how these decisions change over time. So some of these changes are relatively gradual, and they take an entire lifetime to occur, but other changes occur in a relatively short period of time in a response to, you know, life events or market events.

So take 2020, for example. There's a whole lot of change in a short period of time really for all of us, changes in how we live, how we feel, and how we choose. And so my role at Fidelity is to help understand: How do we help people make sound decisions in spite of all these changes that are going on in their lives?

COLLEEN: Yeah. So how do these rapid changes like the ones you just mentioned impact our decision making?

ANDY: Yeah, that's a great question. So it depends on who you ask. So if you ask an economist, they would say, well, decisions are the result of rational thinking. But if you ask a behavioral economist, they would tell you that that's only half the story. And the other half is the emotional side of the equation, these sort of, you know, gut reactions, knee jerk responses, intuitive feelings about our options that guide our choices. And in some contexts and for some people, good decisions do come from rational thinking, but in other contexts emotional decision making can actually be a good thing.

So, for example, experts making decisions, like emergency room physicians diagnosing and treating patients in a sort of snap, automatic, quick way can lead to really good outcomes. But for the rest of us and people who aren't experts, emotions can lead us astray. And oftentimes, you know, the emotions tend to win out when it comes to the battle between emotion and reason.

So one of the popular analogies is that emotion is the elephant and reason is the rider. The rider thinks he or she is in control, but really the elephant has a mind of its own. And so as much as we can steer the elephant or try to steer the elephant, the elephant can also lead to making sort of hasty emotional decisions in the heat of the moment.

COLLEEN: Andy, could you give us an example of hasty financial decision making?

ANDY: Sure. So we saw a lot of this in the first half of 2020 when the market tanked on COVID related fears of an economic shutdown. The numbers of clients who called Fidelity and said, "I'm worried. I'm anxious. I'm nervous about the market," absolutely went through the roof. And many of them also sold out of the market at the same time, and it's hard to blame them. After all, they're showing this natural fight-or-flight response that's honed by eons of evolution, but the market isn't a predatory animal, so this innate response doesn't have the same benefit to us as it did to our ancestors.

We're trying to make 21st century decisions based on ancient hardware, and, unfortunately, this sort of runaway reflex leads people to do things like abandon their long term plans and make hasty decisions in the heat of the moment that feel safer and provide short term emotional relief but may actually jeopardize their financial outcomes for years or even decades down the road.

COLLEEN: Yeah. It sounds like that fight-or-flight response kicks in during stressful situations.

ANDY: Absolutely. So when we're stressed, the part of the brain that handles sort of complex thinking, problem solving, higher level reasoning, and self control actually gets deactivated and suppressed by some extent by the emotional part of the brain. So, in other words, when the elephant is spooked, it actually throws the rider off. So it's easier to it's harder, rather, to make patient choices around investing like foregoing smaller gains in the here and now for larger gains down the road when we're feeling stressed out.

COLLEEN: I'm assuming if we let our emotions influence our investment decisions, it might come with a cost. Right?

ANDY: There's certainly a chance. So when fear increases, it's common for people to call their adviser or pull money out of the market. And what the scientific research shows is that the more we fear something, the more risky we perceive it to be and the less beneficial or rewarding we think it is.

Now, on the flip side, when we're really bursting with excitement, we might jump into the market because we think the risks are actually low and the benefits are really high. So there's another way in which emotions can influence our decision making for the worse, which is they can induce us to really try to time the market. And experts will tell you that that's really close to impossible to achieve.

Across the industry and especially in scientific circles, there have been a lot of research attempts to quantify what's the cost, what's the impact that poor timing can have on your investment decisions. And the results are pretty stark. So over a 20 year period, the stock market, as indexed by the S&P 500, returned about 6% on average per year. Now, compare that to the average stock investor's return, which is just over 4%, and you get a pretty big gap of 2%. So much of this gap has been attributed to reactionary decisions to buy or sell based on emotions instead of sticking to a plan. And, unfortunately, the story is even more dire for bond investors who tended to underperform the market by almost 5% during the same time period.

COLLEEN: Wow, fascinating and compelling data. Makes me think: What can we do to make better long term decisions in the heat of the moment to fight those instincts of ours?

ANDY: Yeah, it's no easy task, but I think there's a few strategies that may be helpful. So the first is to have a clear and concrete plan in place to help you resist temptation and stay the course. Really visualize your future and make it concrete. And in particular focusing on the reward at the end of the journey can help you stay patient, especially when the market is volatile. People who have clear financial plans and think farther into the future are less stressed about their finances in the first place.

The second strategy is to seek another person's perspective. Getting a second opinion can really help you counteract the myopia, this sort of tunnel vision, that these heightened emotions produce, and broaden your perspective.

And the third is if nothing else, taking time to reflect on your situation and really think about the things that you're grateful for in your life can be hugely beneficial.

So it turns out that the simple act of practicing gratitude not only boosts our mood and reduces stress but actually has tangible reward and benefits to making long term sort of patient decisions. And I think we could all use an emotional breather these days.

COLLEEN: I'm taking my breath now. I love these strategies, Andy. And here's to us all pausing in future moments that arise and trying to reset our emotions and our reactions and ultimately to improve our decisions.

So thanks so much again for being here and for sharing your insights and helpful tactics. And thanks to all of you for tuning in.

SEGMENT 2: Avoid Mental Money Mistakes

COLLEEN: As we continue our conversation about when to question our financial instincts, I want to pivot to something that I find captivating: pitfalls that we may face as investors.

Many of us have questioned ourselves along our financial journey. So, Andy, what are some common instincts or mental shortcuts that can lead us to make self defeating decisions?

ANDY: There are a lot of investor pitfalls out there. Today we will focus on four of them. But before I dive in, I want to say that the good news is that if you find yourself resonating with these pitfalls, it only means that you are human. So the first pitfall is avoiding losses even when it costs us, and this is the notion of loss aversion. In general, the pain that we experience from losing money is about twice as strong as the pleasure that we get from gaining it. So as a result, people sometimes avoid investing even if it means not reaching their long term goals. And this is understandable when you're talking about long term goals like saving for retirement, saving for a child's college tuition, or investing in a home or business. People really don't want to lose money that they've worked so hard and for so long to save.

COLLEEN: Yeah. Many of us don't like to lose, and I can totally relate to that. We do know, though, that having a plan can help. Planning puts the focus on long term goals and not those short term fears.

ANDY: Right. And if your goal is 20 years away, a loss over a month or even a year probably isn't going to feel that bad over the long run. A colleague of mine once said, "If your house loses 5%

of its value in a year, are you going to sell it?" The answer is probably not. So the question is: Why would you do that when it comes to your investments?

So one thing that can actually make matters worse is ruminating, which is dwelling on negative information over and over and over again. So if you're checking your balances multiple times a day when the market is down, that can actually lead to you to make worse decisions and also feel worse in the long run.

COLLEEN: Yeah. And I do love that analogy, Andy, that you mentioned, because our homes are typically a long term investment, just like our retirement or our college accounts, and it's a good way to put it in perspective.

So switching gears now to the near term, the news cycle today, as you mentioned earlier, it's so short, and there's always some new thing to distract us. So does this contribute to investor mistakes?

ANDY: Absolutely. So we're wired to overemphasize information that we just received because it's more readily available in our minds. This is our second pitfall, and it's usually referred to as the recency bias, but I also call it the breaking news problem.

So when the market is down, we may feel like it's going to keep falling; but, conversely, when it's up, we may feel like it's never going to stop. These intense emotions like fear and excitement that we feel when the market is volatile have a tendency to narrow our focus to the here and now, and this can lead you to invest more at the market tops and sell at the market bottoms.

So our the rational side of our mind is telling us buy low, sell high, but the emotional side, our gut, tells us to do the exact opposite.

COLLEEN: Yeah. This is one of the reasons when I do listen to the news, I seek out many different sources and perspectives. I also relate this to what I tell my kids often about social media, which is put your phone down. Right?

Hone in and focus in on what you're doing, not what everybody else is doing.

So on that note, Andy, what is the next pitfall?

ANDY: So the next pitfall is related to how we get our information, and this is called the confirmation bias. So this means we tend to seek out information that confirms or supports what we already think while we avoid or reject information that doesn't support our beliefs.

So say you've just invested in a company stock and later on you're doing some Internet research on the company, and you might come across a few positive headlines and a few negative ones.

Confirmation bias tells us that you're going to selectively click on those positive ones because it confirms your belief that this stock is a good investment and selectively avoid the negative ones and in doing so potentially miss some important warning signs.

COLLEEN: This pitfall does seem harder to identify than some of the others, so how can we avoid falling into this trap?

ANDY: Yeah, it's really hard because at the end of the day we really want to feel good about ourselves. And confirmation bias can make us feel like we know what's going on and we have some control over our fates, but if it leads to big mistakes in the long run, you can imagine how this confidence, this false confidence, can ultimately make way for regret.

So what's the solution? I think seeking out information from a diverse range of sources is important and especially making sure that they're credible sources. So when it comes to your investments, there's a lot of great educational content and resources here at Fidelity and elsewhere.

COLLEEN: Yeah, that's good information to consider. So what's the last investor pitfall, Andy?

ANDY: So the last one is herding bias. So humans are social creatures, and we tend to follow the crowd. We save time and mental energy by doing what other people around us do. So when multiple people in your life start talking about a particular investment, it's normal to start to wonder if it's that popular, maybe it's worth investing in.

So think Internet stocks in 2001 or cryptocurrency more recently, or the latest meme stock to go viral. If friends and family in your neighborhood are talking about something that they read about on, you know, social media, it may be wise to take a step back and instead of following the crowd, focus on developing investment decisions that are right for you.

So this is an area where being selfish, being a little egotistical can be good in a way. After all, everybody's preferences, everybody's goals, everybody's needs are different when it comes to investing.

COLLEEN: Yeah. It can be so hard, though, to not follow the crowd, as you said. And thinking about your goals and what you want when it comes to investment decisions is really helpful.

Now let's recap what we can do to avoid falling into these four traps, Andy.

ANDY: Yeah. I think there's four basic strategies. So, first, focus on your long term goals, not your short term fears, as hard as that may seem.

Second, don't let headlines or heartlines take over your decisions.

Third, try to see the big picture. So ask yourself: What could I have gotten wrong? And seek information from diverse sources.

Last but not least, don't just follow the crowd. Do your homework and chart your own course.

COLLEEN: Yeah. So I would add a fifth to that, Andy, which is you can monitor your investments and the progress towards your goals on a set schedule, whether it's once a year or when your goals change. I know I've found it helpful when working with a professional, someone who's reviewed my mix of investments, it's really helped me to remove the emotions and to have greater confidence in my overall plan.

So, again, thanks so much for joining us, Andy. Really appreciate your time and the valuable information that you have shared. And thanks to all of you for watching.

SEGMENT 3: Manage Emotions to Achieve Your Goals

COLLEEN: It's been an emotional roller coaster during the COVID pandemic, and I know a big part of that for me, it's been due to the social distancing.

So, Andy, can you touch on this from a health perspective before we tee up the potential financial implications?

ANDY: Yeah, you're right, Colleen, that social distancing has a really negative impact on both mental and physical health for a lot of us. We've seen this from everyone from kids to older adults.

On the mental health side, there's been actually a growing trend going back a few decades in the U.S. towards the erosion of social connections and community that are really critical to our collective well being.

As a social species, the lack of human contact can be really harmful to our emotions and subjective well being, and we've seen this play out in skyrocketing rates of clinical depression and anxiety. On the physical side, when we stay at home, our sedentary time tends to increase, which is extremely harmful to our health, our happiness, and ultimately our longevity. So the lack of social and physical stimulation is potentially quite dangerous.

COLLEEN: Andy, I know I've been trying to focus on the immediate silver linings that arose like me adopting two puppies. It makes me wonder about the way we approach short term investing, though. Is social distancing having an impact on that too?

ANDY: Yeah, that's an interesting question. So from a behavioral economics perspective, we've really seen the perfect storm of psychological and environmental factors. So last year we saw a

rise in people investing and even day trading that was often chalked up to a mix of free time, disposable income, and the desire for gambling like excitement.

Now, more recently, we've seen a different force, which is the power of the crowd in action, when lots of investors piled into stocks based on social media frenzies. So you have a large group of mostly younger people who are ready, willing, and eager to make a risky and emotionally charged decision en masse.

So imagine millions of people rushing to the pet store to buy a puppy. Puppies may be cute and cuddly, but they also have a big responsibility. So when it comes to making important decisions, reward and risk often go hand in hand.

COLLEEN: Hmm. Now, it makes me think, what about short term goals like saving and emergency, you know, emergency or rainy-day fund or hopefully a vacation that many of us have put on hold? Any thoughts on how social distancing has influenced us in this space?

ANDY: So a lot of people were actually able to start or add to their rainy-day funds during the pandemic. But hopefully the sense of security and confidence that comes from having a savings cushion will encourage people to stick with it.

COLLEEN: Yeah. So given what you have shared, Andy, what about people who are soon to retire or hope to do so in the next one or two years? How can people put their emotions aside and protect what they've been building during their lifetimes?

ANDY: That's a really tough one. So at a fundamental level, when we approach these meaningful endings in our life like retirement, it tends to shift our focus to the here and now and really emphasize what's meaningful in our lives. But for people who can see retirement on the horizon, it's important not to lose sight of the long term.

So retirement can last 20, 30 years, even longer. It's a full third phase of life. So making hasty decisions about a third of your life based on emotional reactions in the here and now doesn't necessarily make a whole lot of sense, so it may be time to reassess and modify your goals and plans rather than making those hasty emotional judgments.

COLLEEN: All right. So you're making me wonder about the people who have decided to push out their retirement by a year or more. What thoughts do you want to share with this group of people?

ANDY: Yeah. I would say don't be afraid to change your plans to ensure long term success. Maybe your significant other lost their job or your financial situation changed. A great plan doesn't mean it can never be altered. It doesn't have to be set in stone. Instead, it should flex and adapt with

changes in your life. We can't predict what's coming around the corner, but we can prepare, and we can adjust accordingly.

COLLEEN: Oh, totally agree with that statement, Andy. And when I do think about all my plans in life, I've had to constantly pivot, and they've been altered all along the way. And what you have shared has reinforced that for me, so thanks.

And I'd also say it's a good time for us to reiterate your key points for people to consider.

ANDY: Yeah. I think there's three key points to take away. The first is just get moving. Physical and social stimulation are really important to emotional well being. Sharing a walk with a loved one gets you the best of both worlds.

Second is to think long term even if you're approaching retirement. Remember, it can last 30 years or more.

And, third, don't be afraid to change your plans to ensure long term success. Humans have survived for millennia because of their ability to adapt to the environment.

COLLEEN: Well, thank you for those three, Andy. Really appreciate it. It's been a thought-provoking and valuable discussion. I appreciate your time, expertise, and action items.

And, remember, if you need help or just have questions about building or updating your financial plans, call Fidelity to speak to one of our representatives, or you can visit us on our website or download the Fidelity app. Thanks again for joining us.

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1 Source: "Quantitative Analysis of Investor Behavior, 2020," DALBAR, Inc. www.dalbar.com. QAIB uses data from the Investment Company Institute (ICI), Standard & Poor's, Bloomberg Barclays Indices and proprietary sources to compare mutual fund investor returns to an appropriate set of benchmarks. Covering the period from January 1, 2000, to December 31, 2019, the study utilizes mutual fund sales, redemptions, and exchanges each month as the measure of investor behavior. These behaviors reflect the "average investor." Based on this behavior, the analysis calculates the "average investor return" for various periods. These results are then compared to the returns of respective indices. QAIB calculates investor returns as the change in assets, after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns in dollar terms, two percentages are calculated: total investor return rate for the period and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net assets, sales, redemptions, and exchanges for the period. Annualized return rate is calculated as the uniform rate that can be compounded annually for the period under consideration to produce the investor return dollars. The S&P 500® is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation. S&P and S&P 500 are registered service marks of Standard & Poor's Financial Services, LLC. The Bloomberg Barclays US Aggregate Bond Index is an unmanaged market value–weighted index representing securities that are SEC registered, taxable, and dollar denominated. This index covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Bloomberg Barclays government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. Indexes do not take into account the fees and expenses associated with investing, and it is not possible to invest directly in an index.

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