Active is:

Behavioural Finance in the Era of Coronavirus

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No doubt about it, the reaction of the capital markets to the spread of the coronavirus has been dramatic. The "VIX" Index (rightfully referred to as the "Fear Index"), which measures fluctuations in prices ("volatility") on the US stock market, has reached a record level of 80, even exceeding its peak during the financial crisis. The US equity market recorded its greatest one-day loss in 30 years.

The virus is spreading, yet at the same time monetary policy and fiscal countermeasures are being introduced worldwide, so it is advisable for us, as investors, to be self-aware in order to be ready with a carefully considered response. To help, we have put together some thoughts based on behavioural finance, because fear and panic are usually the worst advisers.

Summary

- Rationalize to prevent overreactions.
- Get to know yourself - and then outsmart yourself!
- Think about the strategic allocation for your investments now.
- Also include sustainable aspects in your considerations.

Human, all too human

To be afraid is human, all too human. The next level is panic. The Duden dictionary defines panic as "an overwhelming fear provoked by a sudden threat or danger, which paralyses one's ability to think and leads one to react recklessly". To escape from the danger zone, we must recognise the danger – but without allowing it to control us. We have to think rationally. And this is precisely where behavioural finance can help. You see, it's all about our brain – specifically, the most important parts of the brain, and how they interact.

In his book "Thinking fast and Slow", Richard Kahneman (who along with Amos Tversky is considered one of the fathers of behavioural finance) essentially drew a distinction between two large areas of the brain that have very different functions, pointing out that we cannot know which part of the brain is working at any given point in time. One part of the brain, the so-called limbic system, is very fast, very emotional. This is where the so-called "gut feeling" originates. The other part of the brain, the so-called neocortex, is slower and is in charge of our rational thinking, or careful reasoning. To be exact, we should also include the brain stem. Evolutionarily, it is the oldest part of our brain. This is where the fear centre is located.

The structure of our brain follows evolutionary logic: in the early history of human evolution, those traits that were required for survival were also the ones that developed first. Our ancestors needed to perceive risk and to flee from dangerous situations as quickly as possible. The need for logic arose much later.

As a result, during a crisis, the fear centre is the first to spring into action. When it detects danger, the limbic system takes over and reacts rapidly and instinctively. To do so, it relies on behavioural patterns to escape from the danger zone, without any conscious reasoning. While even today it is important for us to rely on our intuition, it is just as important for us to understand and recognise these processes. But it is also important for us to think rationally in order to avoid overreacting.

Know thyself

If you want to avoid overreacting, you have to be self-aware: why do I react the way I do? What motivates me to take certain actions, for example, regarding investments? What are the effects of the behavioural anomalies, seen in every human, that have been carefully studied by scientists?

To drill deeper into behavioural finance, here is our white paper "Outsmart yourself".

Loss aversion

The best-known behavioural anomaly, whose discovery can be regarded as the birth of behavioural finance, is probably loss aversion. This refers to the fact that the pain we feel from one unit of loss is greater than the pleasure we derive from one unit of gain. In other words: we will be more upset over losing Euro 100 than we will be thrilled about a Euro 100 profit. Accordingly, we place greater weight on the current losses in the capital markets than on previous gains, some of which may have accrued over many years.

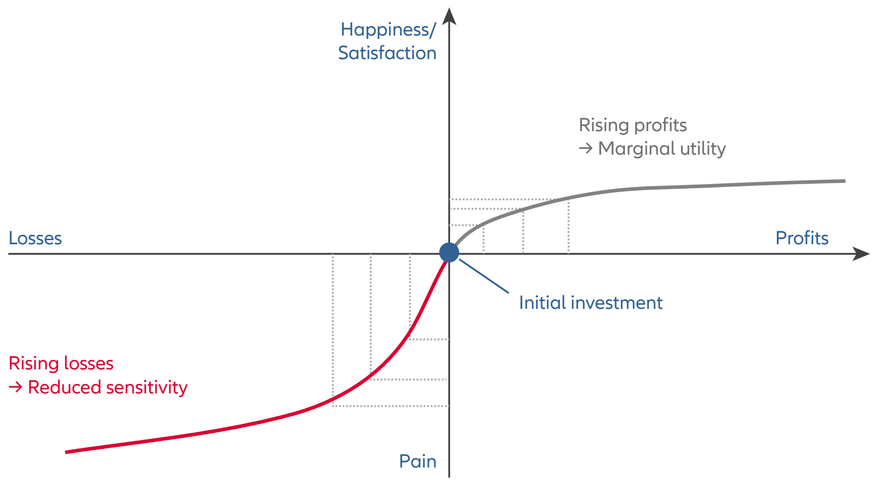
A small window on the big world of investments

Another important anomaly is the so-called "framing effect". We create a frame through which we observe the world (of investments). It functions as a news filter. In the current situation, we focus on all the negative news about the coronavirus – but do we also take into account the countermeasures that have already been taken and/or are still likely to be taken?

In fact, a great deal is currently being done, both in terms of monetary and fiscal policy, and we can expect more to be done in the future. Some of these measures even exceed those adopted during the 2008-09 financial crisis. As of mid-March, more than 30 central banks have lowered their benchmark interest rates. The European Central Bank (ECB) has launched a new Euro 750 billion bond-purchase programme. In order to restore stability and, above all, confidence among investors and/or companies, and to mitigate the negative impact on companies and the economy, numerous governments around the world have also announced fiscal packages, some of them quite massive. The US alone is considering an economic rescue package in excess of U.S. Dollar 1 trillion. In addition to tax deferrals, the focus is mainly on guarantees for corporate loans, which amount to 12% of GDP in France and 15% in the UK.

Are investors aware of this, or are these efforts being ignored due to the "framing effect"?

Figure 1
Loss aversion



The risk profile of an investor is usually asymmetrical, i.e. losses are weighted more heavily

Source: Andrew W. Lo "The Adaptive Markets Hypothesis",2005; Illustration: AllianzGI GlobalCapital Market & Thematic Research

At the same time, the "framing effect" deceives people into focusing much more on current trends. Looking ahead, the real question should be: what can we expect in the future? When is a recovery likely?

Outsmarting yourself

These findings from behavioural finance suggest some rules of conduct for the present. One thing seems certain already: if central banks around the world flood the markets with liquidity and resume purchases of government bonds in even greater quantities, the low-interest/negative-interest environment can be expected to persist even longer and to expand. In the US, negative Treasury yields appeared for the first time in mid-March 2020. For investors seeking returns, this will only exacerbate the problem.

So, from the standpoint of behavioural finance, what can investors do to avoid being caught on the wrong foot while at the same time not missing the right time to buy?

In my view, the Odysseus Strategy always turns out to be the best strategy: it involves "tying oneself to the mast" in order to achieve one's goals. Like the hero in the Greek epic, who has himself tied to the mast to avoid succumbing to the Sirens' song, investors also need to commit to a strategy that will help them to stay on track.

This raises the following questions:

- How much risk can I tolerate?
- How much can I stand to lose?
- What level of profit do I expect, and over what time horizon?
- What are my expectations for the future?

In short, this is the right time to be thinking about strategic asset allocation. A tip: think holistically, ie, not just about financial assets, but instead all assets – real estate, insurance, pension, and even your own work, as these all produce an income stream.

Devil's advocate

It's important to have a devil's advocate – someone to discuss your thoughts with you, question them and help you to enlarge the frame through which you observe the world. You should also look specifically for trustworthy information and analyses that go beyond the mainstream and beyond the daily news.

Many investors also find it useful to enshrine their commitment in a small "contract". The devil's advocate could be your foil, in which case the contractual commitment might read as follows: Remind me of my plans and help me to keep my eye on my goals, before I act too hastily. Challenge my plans, which may be based on emotion.

Active is: Turning strategy into reality

Once you've determined your strategic asset allocation, you need to implement it. So-called "multi asset" investments can help here. These are portfolios that can invest across all asset classes in an effort to minimise portfolio volatility and make tactical adjustments, ie, to react to the market trend.

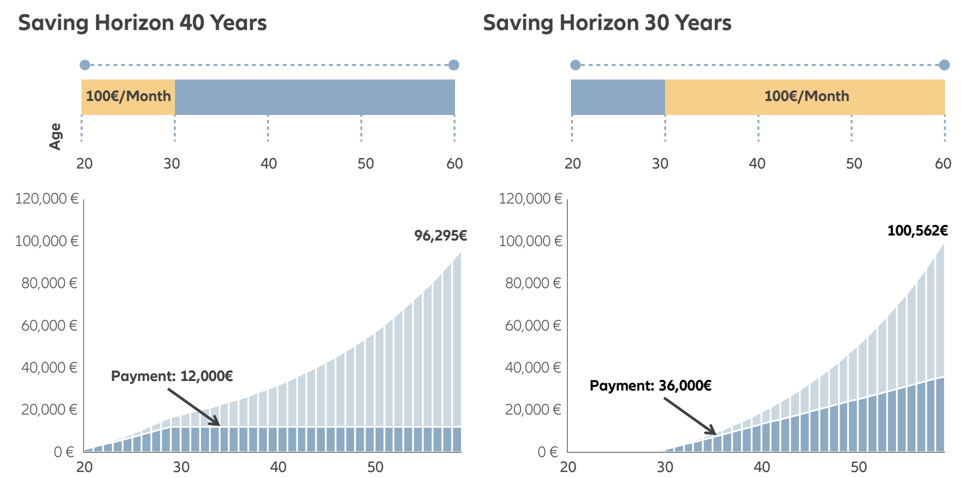
Where greater amounts of money are waiting to be (re-) invested, why not devise a big savings plan? Starting on a specific date, make additional purchases over several quarters in order to reach the desired asset structure. That will smooth out fluctuations and help you avoid betting everything on the right horse at the wrong time.

And, of course, it's always the right time to launch a "small" savings plan, which you can do with just a few Euro per month.

Don't miss our white paper "Using the 7 habits of successful investors".

Figure 2

Better to save "early and little", than "late and much" – assumed yield: 6% p.a.



For demonstration porpuses only. No guarauntee for future resullts. Illustration: AllianzGI Global Capital Market & Thematic Research.

To conclude, I have this tip for you: start thinking about the sustainability of your investments, as well. You can achieve sustainability by applying EGS (environmental, social and governance) criteria as filters when making your investment decisions.

Good luck tying yourself to the mast
(your self-commitment) – and stay healthy.

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