Hardwired to React: Why Investors Make Mistakes That Could Have Been Avoided

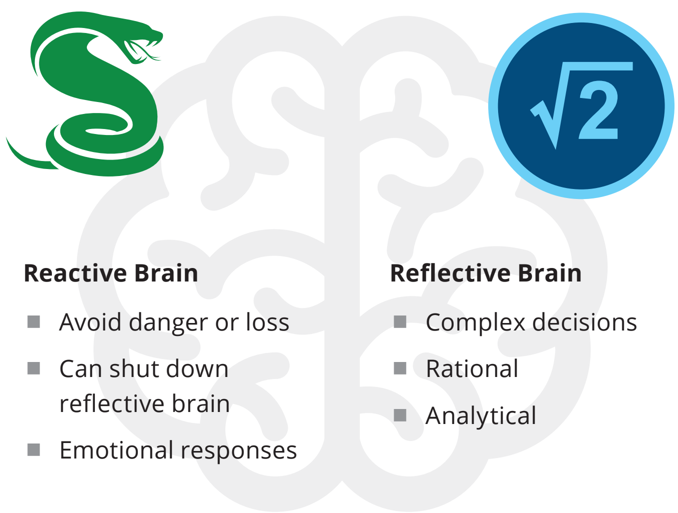
Remaining calm is a Navy Seal's key to success. Yes, they endure extreme combat training. But during a mission, all that training would be useless if they couldn't control their emotions. To remain calm, they use "box breathing." You can try it by breathing in for four seconds, holding your breath for four seconds, exhaling for four seconds, and holding your lungs empty for four seconds. Repeat it a few times. In the most stressful situations, box breathing helps Seals remain calm.[1]

Similarly, investors need to remain calm when market volatility strikes, but it can be difficult to control our emotions. When we fear losing money or missing out on gains, emotions can influence our decision-making ability. Like the Seals, we need a way to control our emotions to avoid making decisions that could hurt our long-term results.

In This Article You'll Learn:

- Two parts of our brain with different objectives
- When our reactive brain takes over
- How we resist our reactive brain when the market drops

Functions of the Reactive and Reflective Parts of Our Brains



Reactive Brain

- Avoid danger or loss
- Can shut down reflective brain
- Emotional responses

Reflective Brain

- Complex decisions
- Rational
- Analytical

1. Two Parts of Our Brain With Different Objectives

Imagine you're taking a relaxing walk down a trail. Suddenly, a snake slithers on the path in front of you. Do you start trying to determine what kind of snake it is, or whether or not it's poisonous? Probably not. Most of us, except snake enthusiasts, automatically stop, jump back, and start walking backward.

This type of response is caused by what neuroscientists call our reactive brain. It's the part of our brain that helps us avoid danger or loss.[2] With investing, it reacts when we're afraid of losing money. It can also react with excitement when we have a big gain or worry if we're afraid of missing one. For example, our reactive brain is activated when people in the office pool their money together to buy a lottery ticket. Our reactive brain wants us to participate so we don't miss out on a windfall.

Another part of our brain is what's called the reflective brain. It performs complex decision-making and planning, e.g. solving a calculus problem, or following a recipe. How the reactive and reflective parts of our brain work together can have significant effects on our investment results.

2. When Our Reactive Brain Takes Over

We like to think of ourselves as rational decision-makers when it comes to investing. We envision ourselves building a long-term plan, with a diversified portfolio of stocks, bonds, and cash investments —and sticking with it. But sometimes, market volatility can influence our rational outlook, such as an 1,000- or 2,000-point drop or rise in the Dow (See Figure 1). Many things can drive volatility, such as trade deals, national debt, interest rates, and more recently, a pandemic. Dramatic headlines often follow, proclaiming either soaring or plunging markets, which can cause our rational mindset to go haywire.[2]

Sometimes, those big point drops turn into bear markets (typically defined as a 20% market drop). Since WWII, there have been 14 bear markets—on average, about one about every 5.6 years.[3] When they happen, do you think to yourself, "Oh, that's just another bear market. I'm a long-term investor, so I'm not going to give in to fear by changing my portfolio"? Possibly.

Figure 1. Big Drops and Rises Activate Our Reactive Brains

The Dow's Largest Point Losses and Gains

Largest Daily Point Gains	
3/24/2020	2,112.98
3/13/2020	1,985.00
4/6/2020	1,627.46
3/26/2020	1,351.62
3/2/2020	1,293.96

Largest Daily Point Losses	
3/16/2020	-2,997.10
3/12/2020	-2,352.60
3/9/2020	-2,013.76
6/11/2020	-1,861.82
3/11/2020	-1,464.94

When our reactive brain responds to large drops or rises, we can be tempted to change our portfolios.

Past performance does not guarantee future results. Investors cannot directly invest in an index.

Source: Factset, 2024

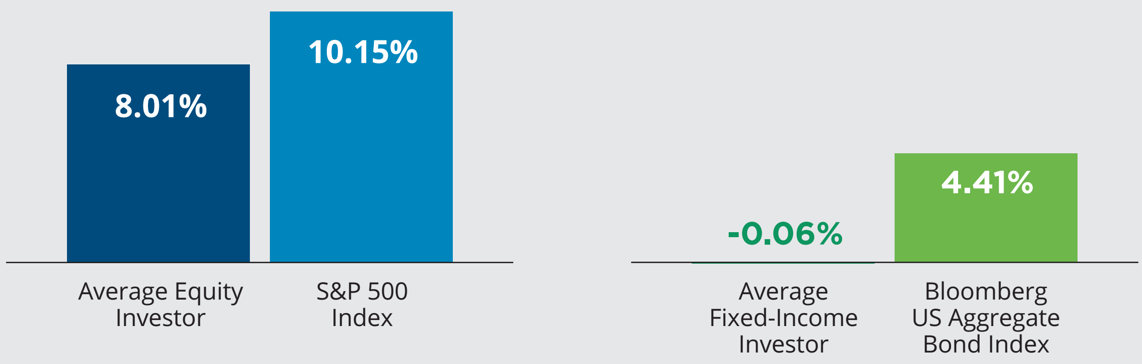
But often a bear market can cause a different reaction—one that causes investors to question their investment plans. News about market drops can trigger our reactive brain in about 12 milliseconds.[2] Because its function is to help us avoid danger and loss, our reactive brain can tempt us to change our portfolio to avert losing more money.

But What About Our Reflective Brain?

Can't our more rational reflective brain counter the emotional response of the reactive brain? Unlike the reactive brains 12-millisecond response speed, the reflective brain takes 40 milliseconds for the market-drop news to reach it—more than three times longer.[2] By that time, our reactive brain

Figure 2. Individual Investors Have Underperformed Market Indices

Average Annual Returns for the 30 Year Period Ending 12/31/2023



Past performance does not guarantee future results. Performance data for indices represents a lump-sum investment in January 1994 to December 2023 with no withdrawals. Indices are unmanaged, unavailable for direct investment, and do not reflect fees, expenses, or sales charges.

See back cover for index descriptions.

Dalbar's Quantitative Analysis of Investor Behavior Methodology - Dalbar's Quantitative Analysis of Investor Behavior uses data from the Investment Company Institute (ICI), Standard & Poor's, and Bloomberg Index Products to compare mutual fund investor returns to an appropriate set of benchmarks. Covering the period from January 1, 1994 to December 31, 2023, 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.

Average equity investor and average bond investor performance results are calculated using data supplied by ICI. Investor returns are represented by the change in total mutual fund 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 for the period examined: total investor return rate and annualized investor return rate. Total investor return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for each period.

may have already taken control of our decision-making, essentially shutting down the reflective brain's more rational perspective.[2]

When Our Reactive Brain Takes Over, We're More Likely to Make Decisions That Could Hurt Long-Term Results

We may be more apt to choose safer investments during market volatility. As a result, we could miss recoveries. Alternatively, after a series of upward market moves, we may choose more aggressive investments, then experience significant losses if the market drops again. Over time, these kinds of reactive decisions tend to reduce the returns of individual investors.

Dalbar's Quantitative Analysis of Investor Behavior demonstrates that emotions can get the best of investors when it comes to decision-making. Over the past 30 years, based on average annual returns, the average equity investor underperformed the market each year by an average of 2.14%. The market returned 10.15%, while the average equity investor's return was 8.01% (See Figure 2).

The reactive brain can hinder investment outcomes by causing psychological traps, triggers, and misconceptions that lead to irrational behavior. This irrationality often results in buying and selling at the wrong times, ultimately leading to underperformance.

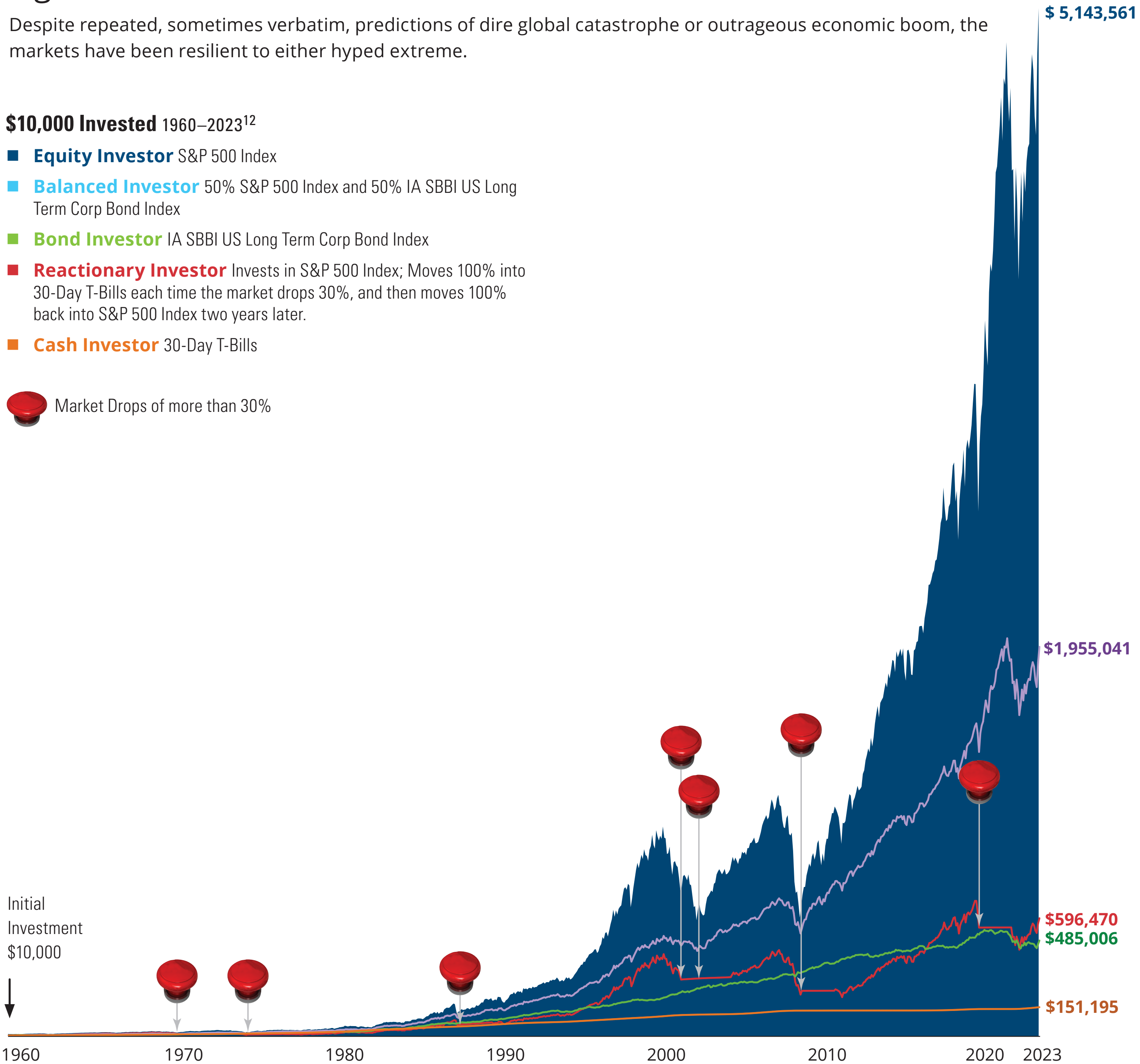
3. How We Can Resist Our Reactive Brain When the Market Drops

There's plenty of information online to help you build a portfolio yourself. There are also online services that will do it for you. These options may be cheaper than hiring a financial professional, but building a portfolio is only one aspect of investing.

How you manage that portfolio over time will affect your long-term results. Will you be able to control your emotions when your reactive brain wants to take over during market volatility? There are resources that can teach investors how to remain calm and make rational investment decisions. However, many investors may not have the time or motivation to learn these techniques. And even if they did, it doesn't guarantee that they won't make mistakes in a market meltdown.

Figure 3. The Price of Panic

Despite repeated, sometimes verbatim, predictions of dire global catastrophe or outrageous economic boom, the markets have been resilient to either hyped extreme.



When the market drops 30%, it's possible for our reactive brain to influence decision making. We can be tempted to make our portfolio safer, like the Reactionary Investor did in the graph above. Historically, those panicked decisions hurt investment returns.

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS. See back cover for index descriptions.

For Illustrative purposes only. Indices are unmanaged and not available for direct investment. U.S. Treasury securities are backed by the full faith and credit of the U.S. Government. Equities and bonds are subject to risks. Source: Ned Davis Research, 12/23

A financial professional can help you manage your emotions and decision-making when your reactive brain tries to take over. They've seen bear markets come and go. They know how to weather the storm when markets get rough.

On the surface, hiring a financial professional will cost you more than managing your portfolio yourself. Many financial professionals charge a percentage of an investor's balance, typically about 1% a year.[4]

But that 1% fee may be worth it, especially if a financial professional could help you avoid the types of mistakes that caused to the individual investor to underperform the market by 2.14% (See Figure 2).[2]

"But Even With a Financial Professional, I Still Can't Stand Losing Money"

A financial professional could help you avoid emotion-based investment decisions. But ultimately, you're in control of your decisions. At any time, you can tell your financial professional that you can't take any more market volatility and want to change your portfolio. The financial professional will honor your decision. So if you choose to work with a financial professional, you'll have to decide if you're going to trust their guidance when volatility strikes.

Remember 3 Things About Decision-Making During Periods of Market Volatility

First, realize that your brain has two parts that are involved with decision making, the reactive and reflective systems. Second, when volatility strikes, your reactive brain can overpower and even shut down your reflective brain. When the reactive brain takes over, you can be apt to make emotionally-based decisions. Third, a financial professional could help you avoid emotionally-based investment mistakes.

Sticking to a Plan Can Be Difficult

If you look at investment history, achieving investment success appears pretty simple (See Figure 3). Stocks had more volatility, but they outperformed bonds and cash. That's why many investors build a portfolio over-weighted in stocks, and stick with it for the long-term.

But sticking with that plan isn't easy. Remaining calm under stress, like a Navy Seal, can be extremely difficult, especially during times of volatility. During bear markets our reactive brain can take control and tempt us to change our plan to minimize losses. A financial professional can help you resist these urges and keep your plan in place.

Next Steps:

- Reflect on past periods of market volatility, e.g. The Great Recession of 2007-2009, or when the market dropped nearly 20% in December 2018, or the bear market in 2020
- Think about how you responded. Were you tempted to change your portfolio? Did you?
- Have a conversation with your financial professional about how he or she could help you respond during future market volatility

Sources:

[1] *How To De-Stress In 5 Minutes Or Less, According To A Navy SEAL*, Forbes, 5/30/19. Most recent data available.

[2] Lennick, Doug. Financial intelligence, FPA Press, 4/21/2010. Most recent data available.

[3] Ned Davis Research, 12/23

[4] *How Much Does A Financial Advisor Cost?* Forbes, 6/12/23

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Index Descriptions

Indices are unmanaged, and unavailable for direct investment, and do not represent the performance of any Hartford Funds.

Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

Bloomberg US Aggregate Bond Index is composed of securities that covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

IA SBBI US LT Corp The index measures the performance of US dollar-denominated bonds issued in the US investment-grade bond market including US and non-US corporate securities that have at least ten years to maturity and a credit rating of AAA/AA.

IA SBBI US 30 Day TBill The index measures the performance of a single issue of outstanding Treasury Bill which matures closest to, but not beyond, one month from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue. The index is calculated by Morningstar and the raw data is from WSJ.

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