ON THE
MONEY

Shock Therapy

How to recover from financial traumas

BY ROBERT FRICK

The two most stubborn people I've ever tried to get into the stock market could not be more different. One was in the Greatest Generation, and one is a millennial. Personalities: different. Temperaments: different.

But the one thing they have in common is they both lived through financial shocks. For my father, it was the Great Depression. For my son-in-law, it was the Great Recession, and the Internet Bubble.

Research shows that these, and other such traumas, can have a lasting effect on investor behavior even decades after the fact.

In their 2011 paper, "Depression Babies: How Our Economic Experiences Affect Investment Behavior," professors Stefan Nagel and Ulrike Malmendier looked at 40 years' worth of data. Not surprising, the young-adult group that experienced the Great Depression had the lowest market participation rate: half—or more than half—of all the other groups.

The group who experienced the post–World War II boom years as young adults loved investing, as did those who came along behind them. But the group who lived through the lousy stock market and high inflation of the 1970s became timid investors in the 1980s.

And the study found that those who had high stock-market returns throughout their lives took on more risk and invested more of their wealth in stocks. Those who lived through a period of high inflation were less likely to invest in bonds—high inflation means higher interest rates, which kills bond prices.

Two factors magnified the effect: Age and timing. The younger you are, the more of an influence an event will have on your thinking. This makes intuitive sense because you have less experience to put something in context.

So while the younger investors grew timid in the 1980s, older investors didn't pull back as much because they still had fond memories of good investment returns in the 1950s and 1960s.

And the more recent the event, the greater its influence. This follows a boatload of research on the *recency bias,* in which recent events skew our perceptions. It's why, for example, sales of flight insurance spike after a plane crash.

Older, Not Wiser

Just because older investors have more perspective doesn't mean the Internet Bubble bursting in 2000 and the 2008 crash that started the Great Recession didn't scare the bejeepers out of us and affect our investing habits. I know my portfolio went from fairly aggressive to stuck-in-moderate after 2008.

And if "Depression Babies" and other studies are to be believed, many investors still are suffering effects from 2008. From investors I know and advisers I've interviewed, I think one of the effects is that many investors believe another meltdown is likely. I'd agree with "possible," but "likely" seems to be a symptom of trauma.

Our brains are wired so that traumatic events seem more likely to reoccur, especially the closer we are to the event. Ever been in a car accident? Remember how paranoid you were for a few weeks or even months afterward that you'd be in another accident?

And from trauma it's not a big leap to post-traumatic stress disorder (PTSD). A study published in a 2012 issue of the *Journal of Financial Therapy* (yes, there is a journal for everything) showed more than half (58%) of financial planners showed signs of post-traumatic stress from the meltdown.

If you're empathetic at all and your clients had just gotten creamed financially, you'd need a pretty hard heart not to feel their pain and suffer from stress. Financial adviser Daniel Lash of VLP Financial Advisors in Vienna, Va., says counseling his clients in the aftermath of 2008 meant helping them deal with shock and depression. And he and other advisers had to deal with those issues themselves.

How did he work through it? "I talked to other advisers in my office and other advisers I know." Speaking with someone who can identify with your situation is key, Lash said. "My spouse was willing to listen, but it was hard for her to bring any thoughts on how I could get through it."

Guilt Complex

In addition to shock and depression, advisers report that guilt is a common emotion clients have felt since 2008. The guilt comes from letting family members down for the financial setbacks they may have suffered because the client made investing mistakes. Those mistakes may have meant delaying retirement or more loans to get a child through college.

Financial guilt is an emotion that lurks in the shadows and is best brought into the open, says Iris Dayoub of Alpha Financial Management in Savannah, Ga. Dayoub says she saw portfolio and emotional fallout from 2008, particularly in clients who managed their own money in 401(k) accounts. Those accounts tended not to be well diversified, she says.

And you should know that other types of trauma can affect your investing outlook. A 2005 Rand Corp. study titled "Health Risk and Portfolio Choice" showed that health problems may explain 60% or more of the decline in financial risk taken after retirement. And a study (*Contemporary Economic Policy*, 2012) of veterans with combat service showed they also took fewer risks with their investments.

Advisor Lash says putting the setback in perspective is crucial for clients stuck in cash or in too-conservative portfolios. "A lot of what I do is show them investment returns from the past, and say, 'Yes, you had this bad experience, but you can't extrapolate that forever.' "

And speaking with someone who understands what you've been through, as opposed to just anyone, is also important. This has proven effective in helping veterans suffering from PTSD. In fact, what advisers say works well with their clients follows the recipe for overcoming PTSD.

It includes talking openly about and working through feelings such as guilt and mistrust. Adviser Dayoub says she's still seeing new clients coming in with a 2008 traumatic hangover that's hurting their portfolios. "They don't want to talk about it for a little while, but eventually it comes up. I help them see it's affecting their ability to meet their financial goals."

Robert Frick is managing editor of Personal Finance.