Financial advisors know all too well the influence that emotions and expectations hold over investor behavior. When markets are volatile or down, clients seek refuge from uncertainty and the challenge is talking them off the ledge. When markets are up, the challenge is offering a reasonable argument for not going all-in on the momentum. It’s not surprising that financial advisors around the globe say preventing clients from making emotional decisions is the number-one success factor for their businesses.

If only investors felt the same way.

According to our most recent investor survey, fewer than one-quarter of individuals in the United States believe they would be better able to meet financial goals if they could stop making emotional decisions. This emotional blind spot manifests itself across a wide range of investor behaviors, which we have observed over five years in our survey program. We commonly see investors let their emotions get the better of them in the following three areas:

- Failing to rationalize return expectations with risk tolerances
- Making reactive decisions in periods of market stress
- Assuming one advantage adds up to greater benefits

Each presents a significant obstacle in the pursuit of investment goals. Together, these behaviors can be an all-out roadblock for investors striving to achieve financial security.

**Figure 1: The Expectation Gap**

Risk, Return, and Investor Expectations

Investors across the globe have an optimistic outlook for the performance of their investments, but their expectations are significantly higher than what financial professionals say is realistic. Globally, individuals say they expect returns of 9.5 percent above inflation, a figure that is 79 percent greater than the 5.3 percent that financial advisors believe investors can expect. While the gap is not as great in the United States, investor expectations are still 44 percent higher than what advisors say is realistic. Investors expect 8.5 percent above inflation, U.S. advisors call for 5.9 percent (see figure 1).
Factor in an average inflation rate of 2–3 percent as experienced over the past 50 years and investor expectations move into the range of 12–13-percent annual returns. Pursuing this level of return generally would require significant investments in equities and, in turn, significant exposure to market volatility. The problem with this scenario is that 77 percent of individuals describe themselves as cautious rather than aggressive investors.

Over the past five years we have consistently seen that the majority of investors are not willing to take on high levels of portfolio risk. In our 2015 survey 79 percent of investors said, if forced to choose, they would take safety over investment performance. The percentage of investors agreeing with this premise has changed little since we first posed the question in our 2014 survey, when 75 percent agreed with this statement. This disconnect between the returns individuals expect and the risk they can accept often leads to emotional decisions and critical investment mistakes that ultimately may keep investors from achieving their goals.

**Manage Risk by Managing Expectations**

Outsized expectations can derail the most well-conceived investment plans. One way to keep expectations in check is to continually profile clients to learn what could be shifting their outlook on investment performance:

- Is it time to review risk tolerance? Life-changing events like babies, houses, college, grandchildren, or inheritance can alter how clients view investment risk.
- Do they know how much they need to retire? Many individuals ballpark their retirement income goals. It's important to revisit the assumptions with solid math, especially if yields are low.
- Do you have an investment policy statement in place for each client? If not, it may be time to get client expectations on paper. If you do, it may be time to determine if assumptions have changed or success metrics are clear.

**A Blind Spot for Emotional Decisions**

Advisors recognize the pitfalls presented by emotional investors. They know that emotional decisions are a huge source of investment mistakes for individuals. Moreover, most advisors (88 percent) say that preventing their clients from making such mistakes is a critical success factor for their businesses. This leads to another significant disconnect for investors: They fail to see how emotions can get in the way of rational investment decisions.

When asked which factors would better enable them to achieve their goals, only 29 percent of investors worldwide and 24 percent in the United States said they could do better by avoiding emotional decisions. But by their own admission, they know they are susceptible to emotions. Six in 10 U.S. investors say they struggle to avoid emotional decisions when markets are volatile. Based on their response to hypothetical market losses, many investors may be losing the struggle.

In a research partnership with the Massachusetts Institute of Technology’s (MIT) Lab for Financial Engineering, we have examined how individual investors say they will react to potential market movements. Over the course of two years, more than 20,000 respondents, including individuals, advisors, and institutions, have been presented with a question about how they would respond if the market dropped 10–20 percent over a six-month period. The results demonstrate glaring differences between the inclinations of individuals and professionals.

Buying low and selling high is a foundation of conventional investment wisdom. In the case of a down market, we see that professional investors are more likely to adhere to this principle by adding to their equity positions. Two-thirds of institutional decision-makers say they would increase their equity allocations in this scenario, and only 18 percent said they would sell off stock. Advisors see the same opportunity in the turbulence; 52 percent say they would add to equity allocations. Investors are of another mind altogether. Only 18 percent of investors say they would add to their equity investments when markets are down; 45 percent say they would sell off stock holdings, and 38 percent say they would do nothing. Motivation for these decisions is clearly reflected in investor attitudes toward risk.

When we asked individuals in our 2015 survey how they define risk, they most frequently (35 percent) defined it as losing assets or wealth. This was followed by

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**Table 1: Most Individuals Want a Sure Thing**

<table>
<thead>
<tr>
<th>Payoffs</th>
<th>Expected Payoff</th>
<th>Minimum Payoff</th>
<th>Percent of Investors</th>
<th>Percent of Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% Chance</td>
<td>$28,000</td>
<td>$28,000</td>
<td>40%</td>
<td>20%</td>
</tr>
<tr>
<td>50% Chance</td>
<td>$36,000</td>
<td>$24,000</td>
<td>19%</td>
<td>19%</td>
</tr>
<tr>
<td>50% Chance</td>
<td>$44,000</td>
<td>$20,000</td>
<td>18%</td>
<td>22%</td>
</tr>
<tr>
<td>50% Chance</td>
<td>$52,000</td>
<td>$16,000</td>
<td>12%</td>
<td>10%</td>
</tr>
<tr>
<td>50% Chance</td>
<td>$60,000</td>
<td>$12,000</td>
<td>6%</td>
<td>21%</td>
</tr>
<tr>
<td>50% Chance</td>
<td>$70,000</td>
<td>$2,000</td>
<td>6%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: MIT/Natixis project. Based on findings from the Natixis 2016 Global Survey of Individual Investors conducted by CoreData Research, February–March 2016, which included 7,100 investors in 22 countries, and the Natixis 2016 Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.
In another test case presented in our collaboration with MIT, investors were presented with a series of gambles. Again we found significant differences between the attitudes of institutions and individuals. Given a series of risk propositions ranging from one that guaranteed a win of $28,000 to another that presented a 50-percent chance of winning $70,000 and a 50-percent chance of winning just $2,000, individual investors were most likely to choose the largest guaranteed payoff—and not gamble for a still larger payoff (see table 1).

Institutions, on the other hand, are more likely to look at the proposition as an exercise in risk optimization. More than six in 10 of institutional respondents selected the propositions presenting the greatest risk-reward trade-off.

These results certainly reflect a greater level of sophistication among institutions, but they also illustrate just how much the risk assumptions of investors can cloud investment decisions even when individuals assume they are doing the right thing.

**Frame Risk in More Personal Terms**

Financial professionals see risk as something that can be measured and quantified. We consider the standard deviation, correlation, and tracking error, but clients often see risk in more absolute terms: Will I lose my assets? The following are some ways advisors can help individual clients measure and quantify risk on their own personal terms:

- Meet clients where they are. Make goals, rather than returns, the focal point of investment discussions. Of course you’ll need to explain the how and why of market volatility.
- Remind clients that portfolio decisions have been made with their risk tolerance in mind. Explain holdings in terms of their purpose in the portfolio: “We can expect this investment to be more volatile at times because it is a growth driver. To get exposure to the upside, we’ll also be exposed to market downturns.” Or conversely: “This investment was included with the goal of helping to mitigate risk. It may not have the highs of the overall market, but it also is less likely to have the lows.”
- It’s perhaps most important to recognize a client’s personal definition of risk, then show how portfolio decisions fit with the client’s goals.

Assumptions Expose Investors to Hidden Risks

We see how the tendency to rely on basic emotional assumptions comes into play with investor perceptions of passive investments. Our 2016 survey asked a series of questions about the benefits of index investments. Their responses indicated that three-quarters of investors in the United States understood that index investments offer market returns at a lower fee. But although investors could identify this basic advantage, they also assumed greater benefits than these strategies may offer.

Beyond being aware of the lower fees, about two-thirds of investors also believe that index funds are less risky (71 percent) and will help them to minimize losses (64 percent). It would appear that investors forget the basic physics of investing: Index funds will deliver positive returns when markets are up, but they also will produce losses when markets are down. These misconceptions could be particularly costly for those who are unnerved by market volatility and predisposed to sell in down markets, a decision that could mean realizing significant losses.

We also found that 61 percent believe that passive investments offer access to the best investment opportunities. This is another misconception that could be costly. By their very nature, index funds offer every investment opportunity—the best along with the worst. Financial professionals realize that investors may not have all the facts about their index investments. In the United States, 75 percent of financial advisors believe that investors do not understand the risks associated with index investing. Globally, 77 percent of institutional investors say they believe investors have a false sense of security about passive investments.

**Low Price Doesn’t Always Add Up to Good Value**

Knowing that clients may have misconceptions about passive investments, it’s important to help them understand where active and passive fit in their portfolio strategy.

- Start by explaining why you are willing to pay different fees for actively managed and passive strategies and outline your own expectations for each of their holdings. This is where having command of the numbers can be essential.
- Active share, which measures how an investment’s holdings differ from a benchmark, is an important measure to determine if your active managers are delivering active management. Walking clients through the concept and the numbers on your managers can be a helpful validation of your strategy.
- With advisors and institutions expressing concern over closet benchmarkers—those managers that charge an active fee but deliver something much closer to...
More than investment performance, investors want insight. In fact, U.S. investors rank learning more about their investments as the number-one step they can take toward better enabling themselves to achieve their long-term goals. In short, they want their advisors to help them make better-informed investment decisions.

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Sources
Natixis Global Asset Management. 2016. Global Survey of Individual Investors conducted by CoreData Research (February–March). Survey included 7,100 investors from 22 countries. Global Survey of Financial Advisors conducted by CoreData Research (July). Survey included 2,550 financial advisors in 15 countries. Global Survey of Institutional Investors conducted by CoreData Research in October and November. Survey included 500 institutional investors in 31 countries.

All investing involves risk, including risk of loss.

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