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The Vanguard Advisor's Alpha[®] guide to *proactive* behavioral coaching

Vanguard Research

November 2018

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- Investing is an emotionally charged effort that challenges people to contend with uncertainty and doubt.
- With behavioral coaching, and by keeping the focus on the “3 Ps” discussed herein—planning, proactivity, and positivity—advisors can add considerable value to their client relationships.
- The future is uncertain for everyone. Often, it’s how people—both clients and advisors—deal with this uncertainty that leads to better, mutually beneficial outcomes.

In Brazil there is a river—the Roosevelt—named for the U.S. president who co-led the expedition that first mapped it in the early 1900s. Prior to that, this river was known as *Rio da Dúvida* (River of Doubt).

In many ways, the process of investing is an expedition along a river of doubt, with potential dangers or rewards around every bend. Unlike the hazards in the Amazon, of course, the dangers for investors are often more emotional than physical. Even so—and just as it was for Teddy Roosevelt on his journey—having a trusted guide is often indispensable to success. Financial advisors can guide by serving as behavioral coaches, helping clients navigate their own rivers of doubt. In the process, they can add meaningful value.

Rather than review the litany of biases and heuristics, which have been well-covered throughout the behavioral coaching literature, this paper provides advisors with ready-to-implement tools and strategies that can help guide clients past uncertainty to reach their goals.

What is behavioral coaching?

There isn't a universal definition of behavioral coaching, but the following is reasonable: *To facilitate thinking such that the client succeeds in changing a behavior which would otherwise prevent him or her from achieving their goals.*¹ Just as a coach does in sports, an advisor works with clients to achieve a successful outcome. Through interaction, and at times intervention, they can help increase the probability of better client outcomes (Kinniry et al. 2016).

The Vanguard Advisor's Alpha framework has always recommended that financial advisors focus more on client relationship management than asset management; on people, rather than portfolios (Bennyhoff, Kinniry, and DiJoseph, 2018). Our message is differentiated by this emphasis on relationship management. We also stress the importance of aiming to earn a high level of trust from clients rather than market-beating returns. Outperformance is a worthy goal for an advisor, but the odds of success are long and largely outside the advisor's control. Given this, we feel that our philosophy is better aligned with the best interests of both clients and advisors. The Advisor's Alpha approach to behavioral coaching

is similarly differentiated, emphasizing the "3 Ps" that we believe will lead to greater client satisfaction and investing success: planning, proactivity, and positivity. As **Figure 1** lays out (and as the data from our research support), the path to deeper client relationships and higher levels of client trust—and ultimately to greater referrals and asset retention—runs through behavioral coaching.² We believe that this "virtuous loop" means that behavioral coaching can improve the odds for success for investors *and* advisors.

The 3 Ps: Planning

- A written financial plan is the foundation of behavioral coaching.
- A 'simple' financial plan is better than no plan at all.
- Learn the *why*—the emotional reward for achieving the client's goals.

A written financial plan is an invaluable tool, not only for asset management, but also for relationship management. As a motto, "If you fail to plan, then plan to fail" may be a bit of a hyperbole—but only a bit, particularly if you want to be an effective behavioral coach. In fact, *we consider a written financial plan to be the best foundation for behavioral coaching*, as it provides a perfect base for all of the crucial inputs needed to help an investor reach their goals: their objectives, both near-term and longer-term, as well as their constraints, such as their sensitivity to price fluctuations and taxes. More generally, having a written plan helps ensure that clients understand that investing requires them to intentionally bear risk while seeking rewards. Like Roosevelt embarking on his river journey, they are entering into the unknown voluntarily, and a successful outcome is not guaranteed.

And yet... many advisors are *not* preparing financial plans for their clients. Vanguard recently conducted a survey of approximately 600 financial advisors with at least \$50 million in assets under management, asking them about their use of financial plans with their clients. Based on their responses, it would seem that a meaningful number of advisors do not prepare a plan for even their wealthiest clients (**Figure 2**).

¹ This definition, sourced from www.psychologydictionary.org, has been lightly edited by the author for context.

² For more information, please see Vanguard's Advised Investor Insights™, an ongoing, proprietary research series that provides actionable insights into investor behavior.

Figure 1. Behavioral coaching helps clients *and* advisors

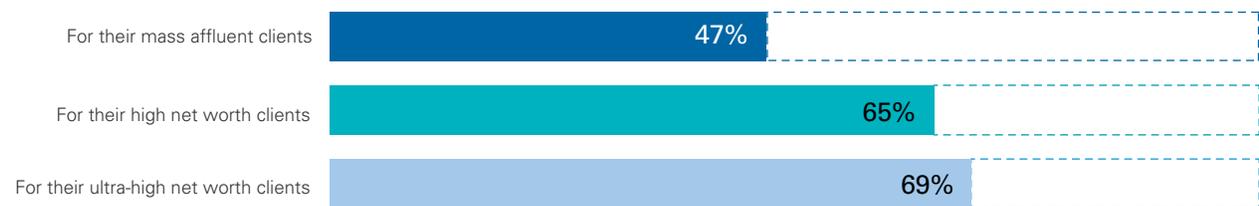


Source: Vanguard.

Figure 2. Which clients are advisors preparing written plans for?

Advisors were asked...

'The proportion of clients I've created a formal, written plan for is...'



Notes: "Mass affluent clients" are defined as investors with between \$100,000 and \$1 million in investable assets; "high net worth clients," as investors with between \$1 million and \$5 million in investable assets; "ultra-high net worth clients," as investors with more than \$5 million in investable assets. Results are based on a Vanguard survey of approximately 600 financial advisors with at least \$50 million in assets under management.

Source: Vanguard.

Why might this be? The advisors' responses revealed some common themes. Many advisors feel that:

- Their clients' circumstances are 'too simple.'
- Financial plans are too complicated or time-consuming.
- Clients hired them to do portfolio or asset management, not financial planning.

Contrary to many advisors' belief that some clients' situations are too simple for a financial plan, it is probably more appropriate to say that some clients' circumstances are too simple for a *complex* financial plan.

For example, say you've begun working with the daughter of one of your clients. She's just reached the point in her life where her attention has turned to paying off student loans and investing for retirement. Obviously, the plan for her will look much different than the one for her parents. That said, both the daughter and her parents can benefit from the structure and built-in support that their respective unique plans would provide. And—as with every other aspect of the client relationship—a financial plan need only be as complicated as their circumstances require.

Although preparing a financial plan at the onset of a new client relationship can be time-consuming, it's a great *use* of time. Remember, time is an asset best *invested*, not *spent*. The investment of time and effort in preparing the plan isn't a chore; it's a gift. In making the plan, you can learn everything you need to know about what the client is investing for and why. Ideally, the process provides you with the insights you require to anticipate the client's needs, both financial and emotional. And anticipating these needs is the most important element of proactive behavioral coaching.

It's worth stressing this: The planning process provides the opportunity to delve into the emotional motives behind a client's goal prioritization. For many investors, their goals—buying a house, paying for their children's or grandchildren's educations, or having enough retirement income—are driven not only by practical considerations but also by emotional ones. The practical aspect of their

goals can often be determined by asking, "How much will that cost?" The emotional aspect, however, requires a more personal approach.

For this aspect, you would want to ask the client, "How would it make you feel to be able to buy that house, pay for that tuition, or have that retirement income?" *Then listen*. In their answers, clients will often provide you with useful insights into *why* they are investing.

Why is this important? Think about the focus of many financial plans. Typically, it's on gathering specific information: the client's goals, risk tolerance (or, depending on your perspective, risk intolerance), tax bracket, time horizon, etc. All of this, of course, is essential information for building an investment strategy to help a client meet their goals, and for meeting regulatory "know your client" requirements. However, without asking about the client's *why*, you have less information than effective behavioral coaching requires. Knowing the *why* is an essential piece of the behavioral coaching tool kit.

Connecting the emotional and practical aspects of the investment strategy can benefit investors and advisors alike. For example, consider the following exchange:

Advisor: *'How would it make you feel to be able to have the money to pay your children's college tuitions, live a comfortable retirement, and make a sizeable donation to charity?'*

Client: *'I believe strongly in the value of education, and making sure my children don't need to go deep into debt for their education is my main concern. I've worked hard during my career, and knowing that I could relax in retirement and not worry about every nickel I spent would give me great peace of mind. And, if possible, I think it would be nice if I could give something to charity.'*

Now, what are the emotional insights we might gain from this exchange, and how can we use this information to help the client? Clearly, the education and retirement goals are much more important to the client than the charitable donation is. Knowing this can help with allocating assets, determining investment strategy,

and behavioral coaching. Given the passion and high priority that the client assigned to the first two goals, it might make sense to allocate a large portion of available assets toward achieving them. And since it appears that the charitable goal is less of a priority, we might allocate a smaller percentage of the initial portfolio toward meeting that objective.

Should the investment strategy for each goal be the same? Perhaps not. For example, it might be prudent to invest the education liability's portion of the portfolio in assets whose returns are more certain, such as zero coupon investment-grade bonds. For the retirement income liability, the strategy might be to put the majority of new capital contributions toward this goal, and perhaps invest this portion of the portfolio in assets with higher expected returns. (If the emotional commitment to the retirement goal was higher, an income annuity might be considered as well.) For the charitable gifting objective, an even higher expected return strategy might be appropriate, with the hope that the strategy's higher return uncertainty may be balanced by the client's lower emotional priority.

This is *goals-based investing*, and while it isn't necessarily appropriate for every investor, it can help some investors cope with market uncertainty and improve their odds of reaching their goals. As with using a systematic investment plan rather than a lump-sum approach, goals-based investing may not be the most rational method for dealing with the investment portfolio—but it may be the most *reasonable approach* when it comes to dealing with the investors themselves.

Understanding the emotional importance of some goals compared to others can help you determine the client's *required return*; that is, the return needed to reach their most important objectives. Too often, clients form investment expectations based on arbitrary goals—such as market-beating returns—that are, quite frankly, both difficult to achieve and unnecessary. As the old proverb asks, “What is the use in running if you're not sure you're on the right road?” In these instances, the client's return expectation is an input to the plan, a *desired return* that can lead to the “wrong road” via a more aggressive asset allocation than would otherwise be prudent (Bennyhoff and Jaconetti, 2016).

The required return, on the other hand, is an *output* of the plan; it's a calculation based on the assets currently available, the additional capital to be contributed, and estimates of future liabilities and spending needs. It is important here to distinguish *wants* from *needs*, so as not to inflate the assets needed to meet future liabilities. “Having more assets in the future” may not seem to be a problematic goal; in fact, it might seem to be the very purpose of investing. But building more wealth for the future involves trade-offs: usually the need for higher capital contributions (and deferred spending) than would otherwise be required, a higher risk portfolio, or both.

Although a client's desired objectives (however idealized) should never be completely ignored, you can use the information gathered when you probed for the *why* to help clients accept—both logically and emotionally—that some goals will need to be prioritized over others. Coaching clients on the role of the required return can help them understand that the road to “more assets” is not necessarily the same as the road to “enough assets.”

The 3 Ps: Proactivity

- Behavioral coaching *in the moment* is most effective when the client has been prepared *in advance*.
- Changes to the portfolio should be motivated by the headlines of clients' lives, not the headlines in the news.
- Proactive behavioral coaching is your ‘antidote’ for the disorder of doubt.

The primary difference between our Advisor's Alpha approach to behavioral coaching and other approaches is its emphasis on being proactive. For advisors, some proactive efforts would seem to be obvious—initiating calls to clients who might be inclined to react to or worry about market-related headlines, for example. Other efforts, at least when applied to behavioral coaching, may not be obvious at all. Those efforts are the ones that we'll focus on in this section.

The financial plan is both the vehicle and the catalyst for most proactive behavioral coaching opportunities. Even a simple plan can provide the framework for behavioral coaching conversations to come. *What are we investing for? What is our benchmark for success? How are we going to build and maintain the portfolio?* Asking and addressing these questions as you create a financial plan with your client helps both of you answer other questions later. For example, consider the following commonly encountered question:

Client: *'The market is down a lot. Isn't this a good time to rebalance?'*

Including a rebalancing rule in the financial plan is but one example of proactive behavioral coaching. When you first present the plan, you can outline exactly the conditions under which rebalancing will occur. While this proactive approach cannot prevent the client question above, it can support better behavioral coaching conversations and, potentially, better client outcomes. Isn't it easier to envision success from an answer like the one below when the question has already been anticipated in the plan?

Advisor: *'Remember when we prepared your financial plan? We discussed that we'd review your portfolio twice a year, but only rebalance if the portfolio had deviated at least 5 percentage points from our strategic asset allocation. Our rebalancing rule means that we never have to ask ourselves a question we can't know the answer to—Is now a good or bad time to rebalance?—only whether now is or isn't the agreed-upon time to rebalance.'*

Another question that the plan should answer is, *What circumstances would be expected to lead to a change in the portfolio or plan?* Similar to rebalancing, some changes to the portfolio or strategy are warranted. However, too often clients believe (or, perhaps more accurately, are led by the media's talking heads to believe) that circumstances requiring changes to investment strategies are more common than they are. While the birth of a child, a pending retirement, or winning the lottery are certainly valid reasons to review the client's plan, most market and news events are not. Make sure the plan clearly spells out that it's the headlines of clients' lives that drive the investment strategy, not the headlines in the news.

Proactive coaching can yield great benefits when it comes to supporting portfolio construction, too. With any investment or investment strategy, return uncertainty commonly results in one of the hardest emotional obstacles to contend with: doubt. It is impossible to know for sure whether or not the strategy will deliver the expected performance in the future. When a period of underperformance is experienced, how can anyone—*client or advisor alike*—be sure the strategy selected wasn't a mistake? The honest answer is, you can't. Even asset classes go through long periods where expectations for their relative performance go unfulfilled.

While it is certainly reasonable for anyone who believes in the relationship of risk and reward to expect stocks to outperform both investment-grade bonds or T-bills over the long run, the 10 years ended 2009 did not do much to validate that expectation. U.S. stocks lost 0.22% over that period, while bonds and T-bills gained 6.33% and 2.84%, respectively.³

This result does not mean that the expectation was incorrect, just that the expectation was not fulfilled during that 10-year period. In decision-making, it is common for people to associate a bad result with a bad decision, but this is often not the case. There's even a name for the phenomenon: *resulting* (Duke 2018). In both 1999 and 2009, it was reasonable—just as it is today—to believe in risk premia over time, yet also know that and that there will likely be times when the results will disappoint. Discussing the potential for such outcomes with clients *in advance* can help them better weather these challenges *in the moment*.

If uncertainty and doubt are unavoidable afflictions that arise from exposure to investing, then perhaps proactive behavioral coaching is the antidote. So how might you use proactive behavioral coaching to defeat doubt?

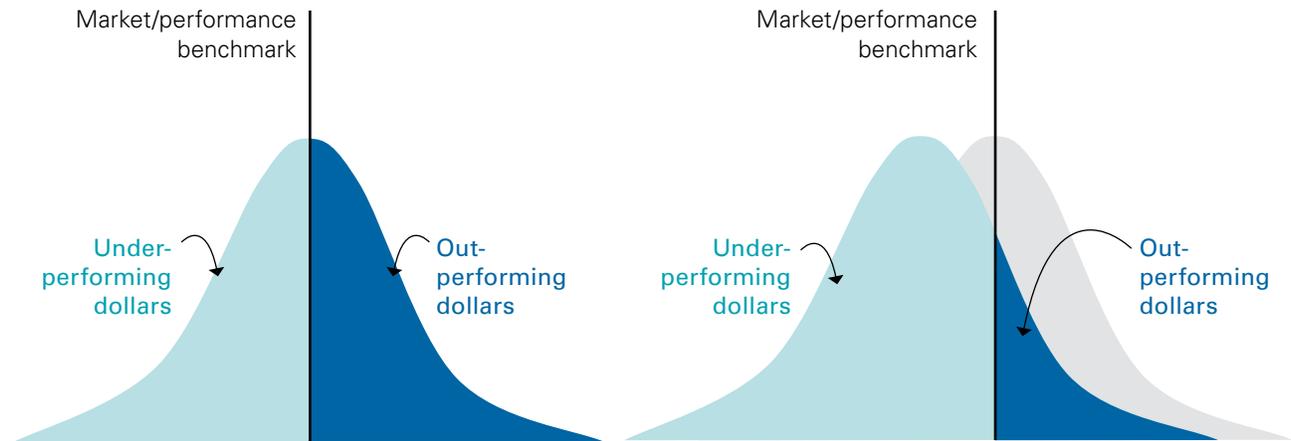
Although many of the factors affecting investment returns are out of investors' control, there are some steps investors can take that can reliably contribute to higher returns over time. Lowering investing costs, including taxes, is one. Investing is a zero-sum game where every dollar that outperforms must be matched by a dollar that underperforms. However, that is before investment management costs and taxes, which erode returns and shrink the opportunity to outperform (Figure 3).

³ U.S. stocks are represented by the Spliced Total Stock Market Index; U.S. bonds, by the Bloomberg Barclays U.S. Aggregate Float Adjusted Index; Treasury bills, by the FTSE 3-Month U.S. T-Bill Index. Spliced Total Stock Market Index: Dow Jones U.S. Total Stock Market Index (formerly known as the Dow Jones Wilshire 5000 Index) through April 22, 2005; MSCI US Broad Market Index through June 2, 2013; CRSP US Total Market Index thereafter.

Figure 3. The zero-sum game and the impact of costs

a. Distribution of investor returns: **before costs**

b. Distribution of investor returns: **after costs**



Source: Vanguard.

Skilled asset management can also improve returns, but it’s important to have a rigorous evaluation process for identifying the talented managers who might provide clients with the best chance for a successful outcome. Explaining the process to clients can help them better understand that the funds chosen for them were selected based on more than just recent returns. That said, talented asset managers, even when they are low-cost, cannot ensure outperformance. This is when behavioral coaching can be especially beneficial, as it helps clients endure periods of underperformance that for even the most capable active managers is normal.

By building portfolios that leverage factors that can more reliably contribute to better portfolio returns and investor outcomes—using lower-cost mutual funds and tax-efficient investment strategies like asset location, for example, and having a rigorous process in place for selecting skillful asset managers—advisors can help clients better understand all they are doing to help them greatly improve the probability of ending on the “right side” of the zero-sum game.

The 3 Ps: Positivity

- The positive approach to behavioral coaching relies on a change in an advisor’s mindset, not a change in skill set.
- Avoid expressing your value as a product of helping keep investors from ‘being emotional’ or ‘making bad decisions.’

The last concept in the Advisor’s Alpha approach to behavioral coaching—positivity—is the easiest of our 3 Ps to integrate immediately into practice, as it is entirely within an advisor’s control. It is a change in mind-set, rather than a change in skill set.

It’s a bit surprising how often the “golden rule” is overlooked, and it’s worth remembering it in this context. Ask yourself how you would feel if a personal trainer tried to explain her value as being there to provide the discipline you lack or to help you eat less and exercise more than you would if you weren’t working with her? Or if a smoking cessation coach

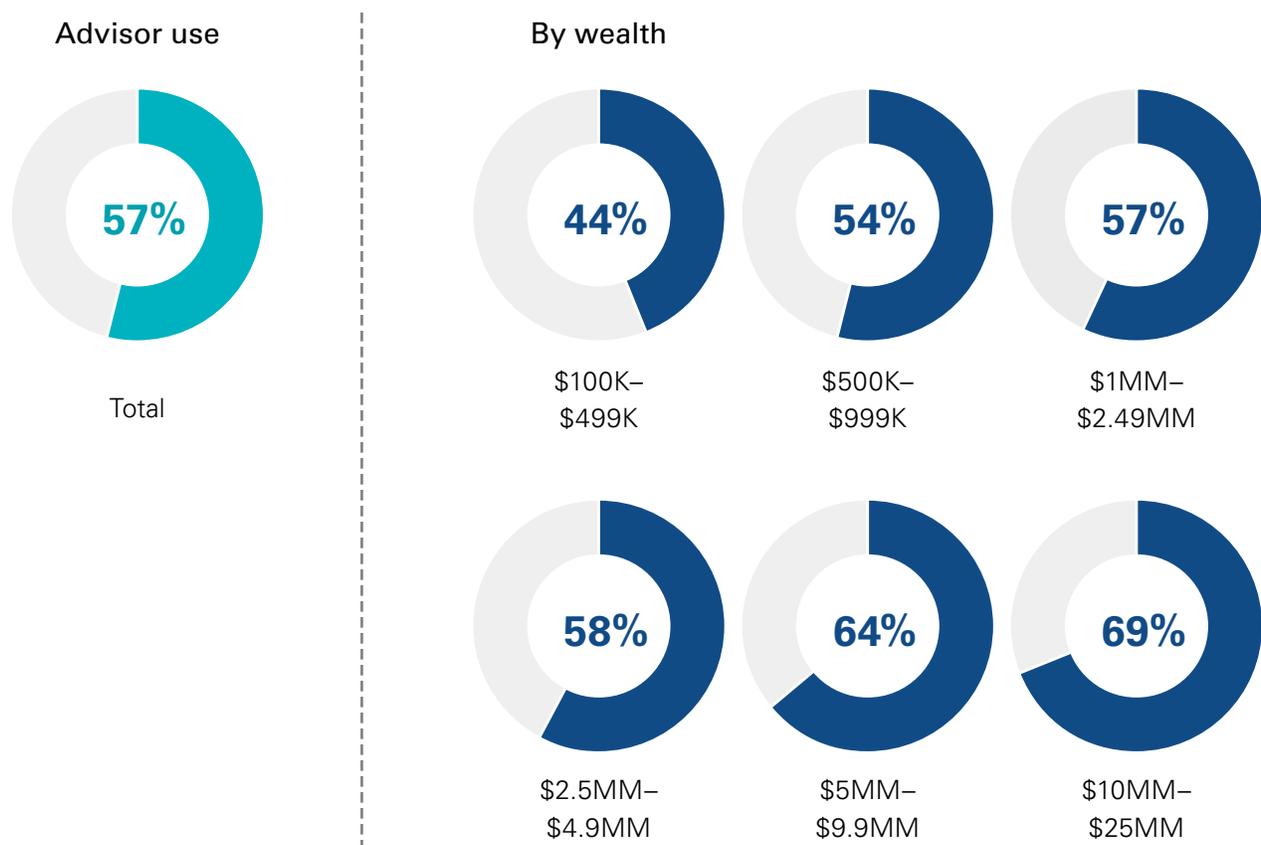
said that you need him to help you quit smoking because, clearly, you can't do it yourself? For most of us, condescension isn't a deal maker; it's a deal breaker. How are these approaches much different from what is often used to explain the value of working with a financial advisor?

It's pretty common to hear that investors "are emotional," "chase returns," or "need hand-holding." Investors *are* often emotional or make decisions they regret—but these are conditions that affect *people*, not just investors, and advisors are not immune. In other words, "those who live in glass houses should not cast stones." Think of those investor return gaps—also called behavior gaps—that illustrate that investors often underperform the funds they invest in because of the

timing of their investment cash flows. However, nearly 60% of investors with more than \$100,000 in net worth report that they use a financial advisor—and that percentage is even greater among higher wealth cohorts (Figure 4). This makes disentangling the decision-maker behind any cash flows more complicated: If cash flows do seem to chase returns, whose idea was it, the client's or the advisor's?

One strength of a positive approach is that it avoids the risk of insulting investors with the suggestion that the mere possession of a securities license or professional designation (such as a Certified Financial Planner™ professional or a CFA® charterholder) means that advisors can't make emotional decisions. After all, advisors are people too, right? The positive approach

Figure 4. The more wealth an investor has, the more likely they are to use an advisor



Source: Spectrem Group.

can help differentiate your value proposition as well. Your admission that emotional decision-making is a potential problem for *people* means that the perseverance and process that the individual advisor provides matters more than the designation itself.

You probably know advisors with similar experience and qualifications as you who might achieve better investment outcomes if they, too, worked with a financial advisor rather than handling their investments themselves. Investing is often intensely personal and it's understandable that people get very emotional when it comes to their investments. Partnering with a financial advisor makes sense for many reasons, but one significant benefit has nothing to do with how much more knowledgeable, rational, or "disciplined" the advisor is compared to their clients. It has everything to do with the fact that *the investments they're entrusted with are not their own*. This detachment allows the advisor to serve as an emotional circuit-breaker, providing objectivity and support when needed.

Conclusion

Behavioral coaching has been a cornerstone of the value proposition for advice for many years. While many advisors have grown very comfortable with *why* behavioral coaching matters, many are not confident that they know just *how* it's done. The good news for all advisors is that learning the "how" is completely within their control.

Effective behavioral coaching does not depend on technology, digital media, or specific client relationship management tools (although these tools can certainly support behavioral coaching efforts). Every advisor already holds the key to behavioral coaching: The coaching must be a conscious effort, proactively applied, to help answer a client's most likely questions or concerns *in advance*. Every conversation with an investor, whether they are a prospect or a long-term client, is an occasion for behavioral coaching. The important thing is to realize this and make the most of each opportunity. The process we've suggested, using the principles from our Advisor's Alpha approach to behavioral coaching—planning, proactivity, and positivity—can help.

A financial plan, however simple, can make any behavioral coaching effort more effective by providing the foundation for understanding not only *what* the client is investing for, but also *why*: their emotional attachment to certain goals. This understanding is a huge help in both preparing an investment strategy and foreseeing which emotional hurdles or concerns are most likely to arise for that client in the future.

Anticipating the factors that might tempt clients to stray from your well-thought-out strategy allows you to remain proactive with your behavioral coaching. More often than not, behavioral coaching is most effective in the moment when much of the work has been done in advance.

Lastly, it's essential to use a positive approach rather than a negative one when explaining the value that advisors and behavioral coaching can provide to clients. The challenges of investing are shared by all people, and again, advisors are people too. The future is uncertain for everyone. Often, it is how people—both clients and advisors—deal with this uncertainty that leads to better investment outcomes.

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Appendix: Actionable ideas and tools for proactive behavioral coaching

Many advisors find illustrations helpful when trying to make a point with clients. Almost every chart can be used for proactive behavioral coaching. To provide some context around this point, we've included three charts as examples, along with ideas about how you can use them (Figures A-1, A-2, and A-3).

The top half of each figure presents a chart as the client would see it; the bottom half presents notes and prompts for the advisor to consider and use when meeting with the client and sharing the chart. Once you see how these charts can be used for effective behavioral coaching, you'll probably find a new, proactive use for many of your own favorite illustrations.

Figure A-1. More risk, more return... over the long term



Notes: Stocks are represented by the Standard & Poor's 90 Index from 1926 to March 3, 1957; the S&P 500 Index from March 4, 1957, through 1974; the Wilshire 5000 Index from 1975 through April 22, 2005; and the MSCI US Broad Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1926 to 1968; the Citigroup High Grade Index from 1969 to 1972; the Bloomberg Barclays U.S. Long Credit AA Index from 1973 to 1975; and the Bloomberg Barclays U.S. Aggregate Bond Index thereafter. Data are through December 31, 2017.
Source: Vanguard.

Advisor's Alpha bite: *With investing, it's never return or risk; it's return for risk. During bull markets, the glass isn't half full or half empty; it's always both*

Useful for: Conversations about asset allocation



During bull markets, investors are often tempted to reach for higher returns through more stock-heavy asset allocations or less diversified portfolios.

Investors' tolerance for risk is often inversely correlated with the magnitude and frequency of losses.



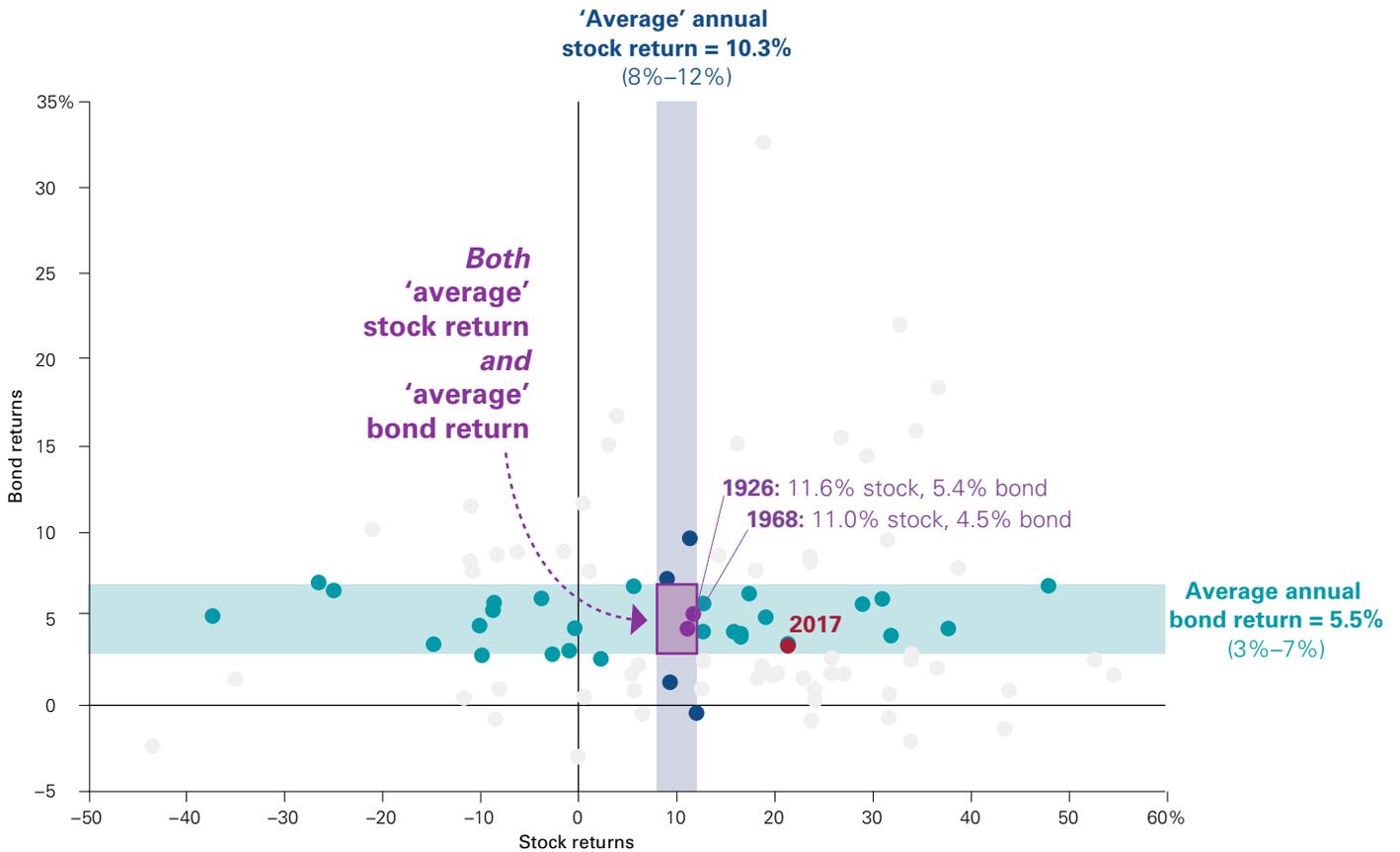
This chart shows that riskier allocations have produced higher average returns, but also a wider dispersion of potential outcomes, particularly on the downside.



While investors may desire the highest possible return, they may not be able to handle the volatility associated with riskier portfolios, and thus can find it hard to stay invested.

The race to wealth is a marathon, not a sprint.

Figure A-2. Returns are almost never 'average'



Notes: Chart shows each calendar year from 1926–2017 (92 points = 92 years), plotted at the intersection of that year’s stock return and that year’s bond return. The vertical shaded area contains all years for which the stock return was between 8% and 12%. The horizontal shaded area contains all years whose bond return was between 3% and 7%. Stock returns are represented by the Standard & Poor’s 500 Index from 1926 to 1974, the Wilshire 5000 Index from 1975 through April 22, 2005, and the MSCI US Broad Market Index thereafter. Bond returns are represented by the S&P High Grade Corporate Index from 1926 to 1968, the Citigroup High Grade Index from 1969 to 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 to 1975, and the Bloomberg Barclays U.S. Aggregate Index from 1976 to 2017.

Source: Vanguard.

Advisor’s Alpha bite: With investing, returns are almost never ‘average’

Useful for: Setting expectations



Much of human knowledge is based on our past experiences: A red-hot stove burned in the past, and will do so again, if we touch it.

With markets uncertain, past long-term returns are often cited as a baseline for what investors might expect from an “average” year.



This chart illustrates annual stock and bond returns for the years 1926 through 2017.

Each point plots the intersection of these two returns. For example, in 2017, stocks returned 21.2% and bonds returned 3.5%.

Average stock and bond returns are indicated in the highlighted bands.

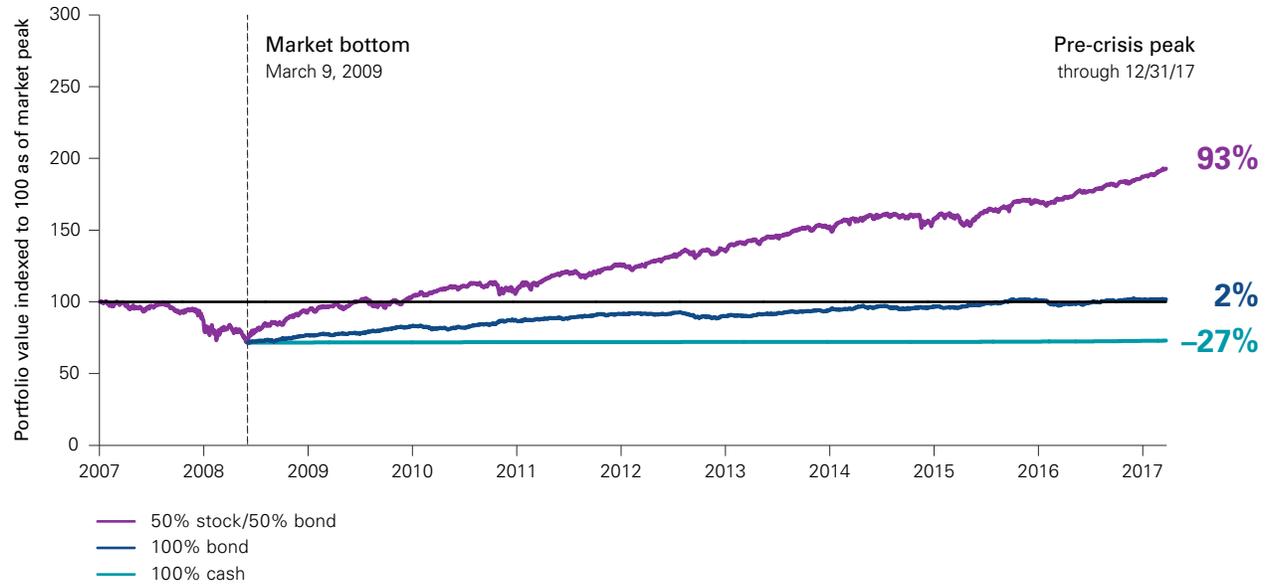


A 10% average annual return for stocks is a well-known and commonly cited statistic.

It’s natural, then, to presume that a 10% return is a reasonable expectation for an average year.

But—as the chart shows—returns are rarely average.

Figure A-3. Perseverance can have its rewards



Notes: Stocks are represented by Standard & Poor’s 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. Cash is represented by the 3-month U.S. Treasury bill. The 50% stock/50% bond portfolio was rebalanced monthly. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Data cover the period from December 31, 2007, through December 31, 2017.
Source: Vanguard calculations, using data from FactSet.

Advisor’s Alpha bite: Usually, when the urge to change is strongest, the benefit of making a change is weakest

Useful for: Conversations about market timing



Timing the market seems easy, but it’s not. To successfully time the market, an investor must not only get out at the right time, but also get back in at the right time.



This chart provides an example of how staying the course can optimize outcomes for investors. The chart also makes clear the potential consequences of abandoning a riskier asset—stocks—to try to avoid loss.



At some point in the future, things will seem bad and you’ll think we need to change our strategy. It’s normal. In bad markets or good, the temptation to change will be strong. And a big loss in the moment always feels much worse than it looks in a chart. But the lessons of the past are clear: Usually, when the urge to change is strongest, the benefit of making a change is weakest.

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