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Why markets are irrational

Take advantage of the "madness of crowds" to become a successful share investor.

**By Shane Oliver, AMP**

Investment markets are driven by more than fundamentals. Investor psychology plays a huge role and helps explain why asset prices go through booms and busts. Investors must be aware of investor psychology and the influence of psychological illusions. The best defence is an awareness of past market cycles so nothing comes as a surprise, and to avoid being sucked into booms and spat out during busts.

Investors looking to trade should do so on a contrarian basis: accumulating when the crowd is panicking, lightening off when it is euphoric

Markets not always efficient

Until the 1980s the dominant theory was that financial markets were efficient – that all relevant information was reflected in asset prices and in a rational manner. Some think it was the global financial crisis, with its collapse in credit markets and consequent 50 per cent fall in global shares that caused faith in the so-called efficient markets hypothesis (EMH) to begin unravelling. But this actually occurred in the 1980s.

It was probably the October 1987 crash that drove the nail in the coffin of the EMH, because it was virtually impossible to explain why US shares fell more than 30 per cent and Australian shares 50 per cent in a two-month period when there was very little new information to justify that. It is also hard to explain the 80 per cent slump in the tech-heavy Nasdaq index between 2000 and 2002 on the basis of fundamentals alone. Sure, there was an economic downturn and slump in IT demand at the time, but this is normal and should have been allowed for in setting share prices.

Study after study has shown that sharemarket volatility is way too high to be explained by investment fundamentals alone. Something else is obviously at play. And that is investor psychology, several aspects of which interact in helping to drive bull and bear phases in investment markets, including individual lapses of logic and crowd psychology.

Individuals are not rational

Many studies by psychologists have shown that people are not rational and suffer from various lapses of logic. The most significant examples are:

- **Extrapolating the present into the future**. People tend to downplay uncertainty and assume recent trends, whether good or bad, will continue.
- **Giving more weight to recent spectacular or personal experiences** in assessing the probability of events occurring. This results in an emotional involvement with an investment strategy. If an investor has experienced a winning investment lately, they are likely to expect that will continue. Once a

bubble gets under way, investors' emotional commitment to it continuing steadily rises, thus helping to perpetuate it.

- **Overconfidence**. People tend to be overconfident in their own investment abilities, particularly men.
- **Too slow in adjusting expectations**. A tendency to be overly conservative in adjusting expectations to new information, doing so slowly over time. This partly explains why bubbles and crashes in sharemarkets normally unfold over long periods.
- **Selective use of information**. Ignoring information that conflicts with current views. People tend to make their own reality, which helps to perpetuate a bubble once it gets under way.
- **Wishful thinking**. People tend to require less information to predict a desirable event than an undesirable one, which may partly explain why asset price bubbles normally precede crashes.
- **Myopic loss aversion**. People dislike losing money more than they like gaining it. Various experiments have found that a potential gain must be twice the potential loss before an investor will consider accepting the risk. An aversion to any loss, particularly in the short term, probably explains why shares traditionally are able to provide a relatively high return (or risk premium) compared with "safer" assets such as cash or government bonds.

The madness of crowds

As if individual irrationality is not enough, it is magnified and reinforced by "crowd psychology", and investment markets have long been seen as providing examples. Collective behaviour in investment markets requires the presence of several things:

- **A means by which behaviour can be contagious.** Mass communication, with the proliferation of financial media in print and electronic form, is a perfect example. More than ever, investors are drawing their information from the same sources, which in turn results in an ever-increasing correlation of views among investors, thus reinforcing trends.
- **Pressure for conformity**. Interaction with friends, monthly performance charts, industry standards and benchmarking, all contribute to herding among investors.
- **A precipitating event or displacement** giving rise to a general belief that motivates investor behaviour. The IT revolution of the late 1990s or the growth in China and emerging markets are classic examples on the positive side. The demise of Lehman Brothers and related events setting off investor panic is an example on the negative side.

- **A general belief that grows and spreads**. For example, that share prices can only go up, or shares are a poor investment. This helps to reinforce the trend set off by the initial displacement.

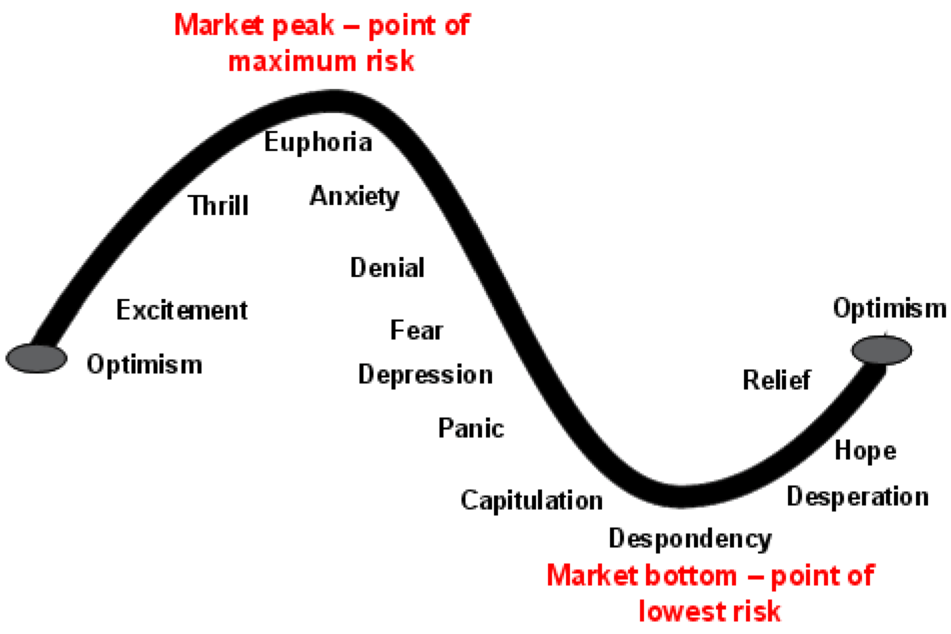
Bubbles and busts

The combination of lapses of logic by individuals in making investment decisions and the magnification of these lapses by crowd psychology, go a long way to explaining why speculative surges in asset prices develop – usually after some good news – and how they feed on themselves as individuals project price gains into the future, exercise wishful thinking and receive positive feedback via the media.

Of course, this also explains how the whole process goes into reverse once buying is exhausted, often triggered by contrary news to that which drove the rise.The chart below, developed many years ago by Russell Investments, shows pretty well how investor psychology appears to develop through a market cycle. When times are good, investors move from optimism to excitement and eventually euphoria as an asset's price – be it shares, housing, gold or whatever – moves higher and higher. By the time the market tops out, investors are maximum bullish and fully invested, often with no one left to buy. This ultimately sets the scene for a bit of bad news to sooner or later push prices lower.

As selling intensifies and prices fall further, investor emotion goes from anxiety to depression, and eventually capitulation and despondency. By the time the market bottoms out, investors are maximum bearish and out of the market. This sets the scene for the market to bottom, as it only requires a bit of good news – or less bad news, as is often the case – to bring back buying, and then the cycle repeats.

Investor emotion through the market cycle



Source: Russell Investments

This pattern has been repeated time and time again over the years. In the late 1990s, investor psychology became euphoric on enthusiasm for tech stocks. Broad media enthusiasm for shares was highlighted by best-selling books such as *Dow 36,000* and *Dow 100,000*. Cracks in the tech boom appeared in March 2000, leading to initial anxiety that eventually gave way to capitulation and despondency in late 2002 and early 2003. By 2007 the focus of investor euphoria had reappeared but was centred on credit, the US housing market and commodities.

In the depths of the GFC in early 2009 this again turned to capitulation and despondency regarding most growth-oriented investments. This in turn helped to set the scene for the recovery in investment markets over the last two years as the GFC subsided and economic data started to improve.

Key messages

There are several points to note from all this. First, confidence and investor psychology do not act in a vacuum. The move from despondency at the bottom of a cycle to euphoria at the top is usually ultimately underpinned by fundamental developments, for example, strong economic growth and easy monetary conditions.

Second, at market extremes, confidence is best read in a contrarian fashion – major bull markets do not start when investors are feeling euphoric and major bear markets do not start when they are feeling depressed. The reason is that by the time investor confidence has reached these extremes, all those wanting to buy or sell have done so, and it only requires a small amount of bad or good news to tip investors back the other way. So extreme low points in investor confidence are often associated with market bottoms, and vice versa for extreme highs.

For this reason, many strategists monitor investor sentiment as a guide to when market extremes may have been reached. Currently, short-term measures of investor sentiment are around average, suggesting no strong reading either way. Longer-term measures suggest investors are still cautious towards shares, which from a contrarian perspective suggests more upside for shares over time.

5 key investment implications

There are a number of implications for investors.

1. **Understand emotions**. Investors need to recognise that investment markets are not only driven by fundamentals, but also by the often-irrational and erratic behaviour of an unstable crowd of other investors. Also, not only are investment markets highly unstable, they can also be highly seductive. Be aware of past market booms and busts, so when they arise in the future you doe not overreact – piling into unstable bubbles near the top or selling everything during busts and locking in a loss at the bottom.
2. **Consider how you react**. Recognise your emotional capabilities. Be aware of how you are influenced by lapses in your own logic and crowd influences. An investor should ask: “Am I highly affected by recent developments (positive or negative)? Am I too confident in my own expectations? Can I bear a paper loss?”
3. **The right strategy**. Choose an investment strategy that can withstand inevitable crises while remaining consistent with your financial objectives and risk tolerance.
4. **Discipline**. Essentially stick to your broad strategy even when surging share prices tempt you to consider a more aggressive approach, or plunging values might suck you into a highly defensive approach.
5. **A contrarian approach**. Finally, if tempted to trade, do so on a contrarian basis. Buy when the crowd is bearish, sell when it is bullish. Extremes of bullishness often signal market tops, and extremes of bearishness often

signal market bottoms. But contrarian investing is not foolproof – just because the crowd looks irrationally bullish or bearish does not mean it can’t get more so.

About the author

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