THE GLOBE AND MAIL

The human flaws that fuelled this market crash – and why they keep failing us when investing

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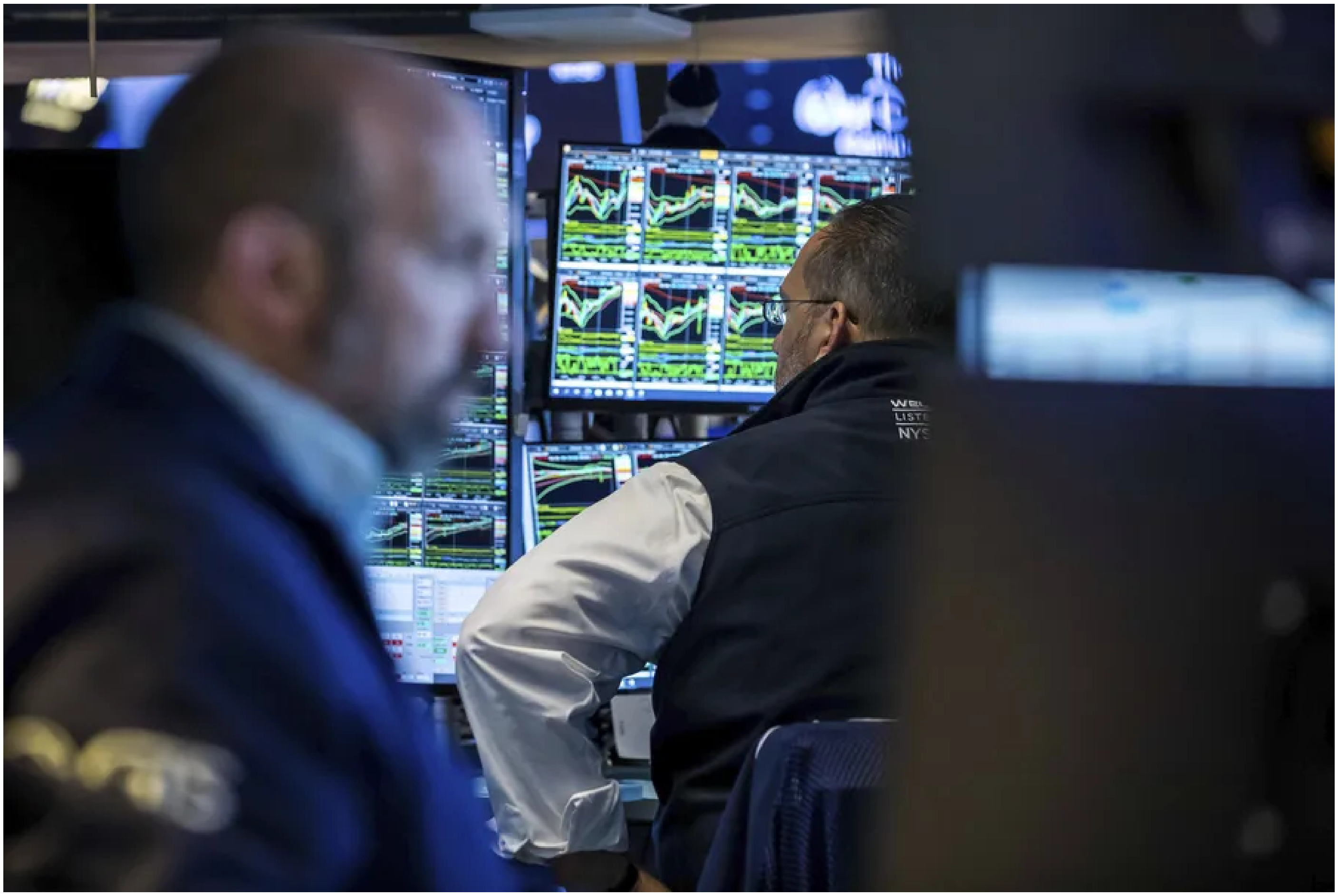

People work at their posts on the floor of the New York Stock Exchange, on May 13.

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Trillions of dollars invested in stocks and cryptocurrencies have evaporated since the tech sector selloff began six months ago, and the last thing investors want to do is blame themselves. But if we're being honest we must admit that we are all partly responsible, because once again our obsession with good stories is a leading culprit.

Until now, rising interest rates have been a convenient scapegoat for the suffering. Growth stocks fare best when interest rates are low, and persistent inflation has forced central banks to reverse the market's tailwind by increasing the cost of borrowing.

But interest rates alone don't explain the shift. What we're seeing now follows a pattern that was also present in each of the ugliest market collapses of the past three decades, including Black Monday, the dot-com crash and the 2008-09 global financial crisis. In each and every one of those market routs, our psychological flaws played a prominent role.

And now it's happening again. It's painful to admit that we could be so silly, because we've been burned before – but believing anything else would be an absurd act of self-defence.

In a way, this shouldn't be all that surprising. A decade ago, behavioural economics became a popular field of study, because it helped explain the global crisis that had nearly sent our financial system into oblivion.

Unlike classical economics, which assumes most people are rational when they make financial decisions, behavioural economics combines psychology and biology to explain our actions. One of its core findings: we can be tricked into making some pretty dumb decisions, because we are prone to character flaws such as envy and overconfidence, which cloud our judgment.

Despite the field's mainstream breakthrough in the aftermath of the global financial crisis, there has been hardly a peep about behavioural economics during the pandemic. If anything, we reverted to traditional models to understand the stock market rally that accompanied the spread of COVID-19. Yet psychological forces were just as powerful as market fundamentals in driving the insanity.

Summarizing these psychological influences can be tricky, because there are so many of them. Terry Odean, a leading professor in the field at the University of California, Berkeley, put it this way in a recent interview: "Nine out of ten times – maybe 99 out of 100 – people are willing to believe stories rather than numbers."

Before COVID-19 emerged, modern investors had never endured a pandemic. Because there were no benchmarks, far too many people started believing in exuberant stories about the possibilities of a digital economy. One of the most popular tales was that in-person everything was over: shopping, work meetings, even physical exercise.

We now know this was wildly optimistic. Online shopping continues to account for around 20 per cent of all retail sales in the U.S., white collar workers never want to hear the words “hop on a Zoom” again and Peloton has only so many rich, athletic people to whom it can sell its internet-connected exercise products. But the theory sure *sounded* nice for a long time.

The same is true of the crypto sector. Crypto companies marketed themselves to retail investors as the future of finance – but, now that we are returning to a somewhat normal way of life, there has been a realization that digital currencies have few practical uses so far.

It’s too late for behavioural economics to tell us whether the bubble will pop, but understanding the field can offer us some guidance as to whether this correction will drag on.

In 2015, some leading behavioural economics researchers drafted a set of principles to help explain the ways flaws in our decision-making affect how we invest. Among their findings is that the suffering inflicted by a loss is about twice as intense as the euphoria produced by a gain of equal magnitude. This helps explain why the recent correction feels so painful, even though the S&P 500 is still up 24 per cent since the start of 2020.

Another principle, and one of the most succinct: “People have self-control problems.”

That can sound basic, because we know it’s true when it comes to other addictive behaviours, such as smoking, or eating unhealthy food. And yet with investing we convince ourselves that everyone buying or selling stocks is making smart decisions.

We do it on the way up, because it’s painful to sit still when it seems like everyone is getting rich and we’re not. During a crash, we do it because no one wants to be the last one holding on.

To be clear, no one knows how this correction ends – and if someone tells you they do, don’t trust them. But here in Canada, we do have a precedent that should be useful as a guide to what’s to come, at least for the frothiest sectors.

When cannabis stocks took off five years ago, their investment thesis was eerily similar to the one for pandemic tech stocks. Investors thought they were getting in on the ground floor of the future.

No matter how ridiculous the valuations were relative to hard numbers, such as the portion of the population that actually smokes weed or does edibles, investors were told – and happily believed – Canadian cannabis companies were set to take over the world.

It was the perfect test for behavioural economics. And we failed, spectacularly. Once the hype was exposed, the selloff was unforgiving, and it didn't stop until there was hardly any value left. Keep that in mind the next time someone tries to argue a company that has never made money is worth tens of billions of dollars.

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