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During crisis, law of the jungle prevails

Karen Mazurkewich, With Files From Eoin Callan Financial Post

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Days after the collapse of Lehman Brothers, the Wall Street investment banking firm, a Canadian chief executive on an emergency visit to headquarters in New York had a strange encounter with a longtime friend who is a stock analyst at a U. S. bank. More unsettling than anything else the chief executive heard on that visit was the bombshell that his friend dropped on him that day: He had withdrawn some of his life savings from the bank and had stashed the bank notes at home.

That's when the visiting Canadian understood the gravity of the crisis of confidence.

"It's like war-time Europe, when people were stuffing money under their mattresses," he says.

Fight or flight is the natural law of the jungle. But the same hormones that ensure the survival of the fittest in the wild is proving to be deadly on Wall Street. The market's extreme gyrations reveal the naked fear among investors.

For decades, classical economics used mathematical models to explain market theory. Psychology was trumped by an empirical approach. Now economists are returning to the view that human behaviour does influence the market because emotions directly impact on the perception of risk.

Most bankers and investors would be surprised to hear that. "Emotions can lead to choices without the decision-maker realizing it," says Jennifer Lerner, director of the Laboratory for Decision Research at Harvard University.

On Thursday, the Toronto Stock Exchange's main index tumbled nearly 814 points -- the biggest drop in eight years -- and the Dow Jones industrial average slid 778 points in just one day. The Chicago Board Options Exchange's Volatility Index hit all-time highs and demand for short-term Treasury Bills dipped into negative territory, the first time since 1940.

That dramatic drop cannot be explained as a rational response to the failure earlier in the week of the U. S. Congress to pass the emergency bank bailout bill.

"They could not possibly have experienced the monetary impact yet," says Ms. Lerner of investors. "Fear makes people perceive more risk and take risk-adverse choices," she adds. Translation: sell, sell sell.

The origins of today's fiasco didn't start with the flight impulse. It began with "irrational exuberance" in the real estate market in the late 1990s and the over-confidence of money lenders, says Hersh Shefrin, a pioneer in behavioural finance at Santa Clara University's Leavey School of Business, and author of Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing. "Their reward centre -- nucleus accumbens -- was really lighting up," he says. That part of the brain drives people to be over-confident. But when things start falling apart, the fear centre of the brain--anterior insula -- lights up, he says. Not surprising, people who are over-confident are also more surprised when things change, he adds.

On the street, emotion is being manifested in a crisis of confidence. Typical investors have become obsessive-compulsive, checking their portfolios by the hour. One busy bank advisor says he is getting triple the calls he usually gets from anxious clients. In times of crisis, financial advisors play the role of oarsmen. "Advisers are playing an invaluable role in creating a sense of calm because of their professionalism," says Randy Ambrosie, president of AGF Funds, Inc.

The fear is manifesting in other ways. "We haven't seen the 'puke' as we call it, that moment when guys are putting down the phone and saying, 'I'm selling everything and I don't care what price I get for it,' " says Doug Clark, managing director, quantitative execution services for BMO Capital Markets.

But he adds that after the House of Representatives announced on Monday that it wouldn't green-light the US$700-billion bailout, an eerie calm descended on the trading floor. "People were standing around the screens in a manner I've only seen twice in the history of the markets: one was 9/11 and one was the O. J. trial."

On Bay Street, the flight impulse has manifested itself in what David Pecaut, a senior partner in The Boston Consulting Group, describes as the "deer frozen in the headlights" response. "We are seeing a split among our clients," says Mr. Pecaut. "Some companies are freezing up, putting projects and decisions on hold, which I think is irrational because this is the best time to be doing things," he says.

Others, however, have chosen to fight back and they are making some fabulous buys, he adds.

"The biggest market-share gains happen during times of economic downturn and crisis," says Mr. Pecaut. That is the message he is delivering to clients.

To say fear is the only emotion evoked by market turmoil would be wrong. The crisis has also stoked anger. According to Ms. Lerner, anger actually leads to optimism, which explains why executives like Warren Buffett have gone on a buying binge.

But anger is a complex emotion and, as behavioural economists such as associate professor Nathan Berg of the University of Texas-Dallas will tell you, humans can be very unforgiving. "We will go out of our way to punish people who violate norms and don't play by the rules," he says.

The average person is angry that the fat cats on Wall Street have caused this crisis. It's a form of cognitive dissonance. "I will sacrifice some money of my own, just to punish you," says Mr. Berg, explaining their irrational behaviour.

But the fight or flight instincts that rule the jungle don't apply as neatly in the modern world where the stimuli is varied and multi-dimensional.

Mr. Shefrin argues that this tendency makes it difficult to strike the right emotional balance: The response is either too hot or too cold.

"There wasn't action when there needed to be action to nip the [credit crisis] in the bud," says Mr. Shefrin. "Now there is over-reaction."

And it's bleeding into the personal lives of people working in the financial sector. One Canadian investment banker based in New York tried to persuade his fiancee to postpone their wedding until "after the credit crisis."

"She wasn't having it," says the young banker, who did not want his name published. He says that he's not alone among colleagues in trying to delay ceremonies until after the skies clear.

"I'm certainly sure that is the case with a lot of Wall Streeters right now," he says.

kmazurkewich@ nationalpost.com