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Why We Buy Into the Herd, Even When It's Not Good for Us

By Michael S. Rosenwald

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After IndyMac Bancorp failed, customers waited in line for hours to collect their money. The police had to be called in to quell the mob. The scenes brought to mind dire moments from the Great Depression. This time, with satellite TV trucks parked outside the bank's branches, the world watched last week as our financial system took another body blow.

On the Federal Deposit Insurance Corp. Web site, IndyMac customers were told: "If the balance in your account . . . is less than \$100,000, no action is required on your part at this time." The money is insured. But Ruben and Rosalie Uranga, who had less than \$100,000 in deposits, lined up anyway, along with many others in similar circumstances.

Why? Though Rosalie Uranga told reporters "Why take a chance?" many behavioral economists watching people herd in line at the bank -- or flush their portfolios of Fannie Mae and Freddie Mac stock -- sense a much deeper, even primal, response at play. I suppose the only way to say this is to just say it: People are acting like frogs.

When a group of frogs senses they are about to be visited by the dreaded snake, they do not hop in separate directions. They bunch up together. And they fight to get in the middle, taking comfort in being further from being eaten by the bad guy. Sheep do it. Minnows do it. It turns out that humans do, too, particularly in financial crashes.

"The safest thing is to run toward the middle," said Elke Weber, a Columbia University business professor who has studied judgment and decision-making. Her correlating four-legged example: gazelles running from lions. "In the middle, surrounded by everyone else, that is where you take comfort. To hide in a crowd is very evolutionary. When you are fearful, you take comfort in herds."

And nothing in recent financial history has provoked as much fear as our current economic downturn, which crescendoed recently with IndyMac's failure; the incessant bad news from other banks; and the federal bailout of Freddie Mac and Fannie Mae, the government-sponsored companies that make the whole U.S. mortgage system work.

Behavioral economists and psychologists see some classic behaviors at play here, leading to herds of people taking measures -- dumping stock, lining up outside banks when they don't need to -- that can actually exacerbate the problems for everyone, causing tornado-like spirals that suck in even wider swaths of people. Though nobody seems to really think that Freddie Mac and Fannie could go under, those stocks have been knocked down significantly.

When the fear buttons are lit up, watch out.

"It makes it difficult for us to think rationally and reasonably," said Hersh Shefrin, a pioneer in behavioral finance and a professor at Santa Clara University.

The instinct is to want to take action, and fast.

"In our studies, what we find is that people in a fearful state will make risk-avoidant choices," said Jennifer Lerner, director of the Laboratory for Decision Research at Harvard University. "The fear drives the goal of reducing uncertainty." So: Sell, sell, sell. "They want to pull their money out because they want that sense of certainty. They can't tolerate the uncertainty," she said.

But why has the response been so intense? People are often more fearful of man-made events than they are of natural ones. "We are rather blasé about nature," said Paul Slovic, the founder of Decision Research, an Oregon nonprofit group that studies human behavior and advises governments. "We think it's generally benign even though we get clobbered by it over and over again. That's why after a big storm we go back and rebuild on the spot."

He continued: "But we are quite the opposite for certain types of risk that are human-caused, particularly if they involve something new or mysterious. We react very strongly to that. . . . If people see signs of incompetence or that the system is not being regulated or controlled, that is very worrisome."

In the case of the subprime mess, investors in retrospect worry that the government did not pay enough attention to overseeing complex mortgage-backed securities.

There are emotions at work, too. When herds of people line up outside the bank for money when they don't need to and when they dump shares and bid down, nearly to zero, the value of companies that don't have a corresponding chance at failure, not only are they trying to run to the center of a big group, but they also want to forestall an emotion nearly as strong as fear. That is, regret.

"When you see a lot of people doing something, even if you think it might be dumb, if it turns out that it was the right thing to do and you didn't do it, you will feel really stupid and your sense of self-esteem will take a huge hit," Shefrin said. "What induces people to herd is in many ways the fear of not doing what the crowd did and then the crowd is proven right."

What if everyone was wrong? "It's a lot more comfortable to be with a lot of people who did the wrong thing," Shefrin said. What's remarkable about this type of behavior is that it shows itself in good times and in bad. "During the bull market, investors told me that they bought stocks even though they thought the market was in a bubble because they were terrified of being left out if they were wrong," he added.

And if they were, in fact, correct and made a lot of money from the run-up, their behavior could reinforce similar herd responses for the way back down, making it difficult to ever figure out when to run with the crowd and when not to.

The contrarian investing option during the housing boom would have been to bet that stocks in the financial sector would decline because so many of the mortgages were bogus. But how many average investors sought out research examining the quality of the mortgages? My guess is not many. But several hedge fund managers did, making huge profits. The everyday investors were too busy covering their behinds with the herd.

I asked several behavioral economists whether there was an antidote to all the financial twitching. Upon hearing my question, several laughed, apparently knowing that it is easier to be descriptive than prescriptive when it comes to human behavior. The phrase "that's the \$64,000 question" was also mentioned at least twice. But upon pressing them, some answers emerged.

For starters, people need to focus on acquiring information that will get them thinking logically, so they at least know whether to sell (or buy) based on actual information, not gut feeling, and definitely not because the neighbors are doing so. The lining-up at IndyMac is a good example: I wonder how many people went to the FDIC's Web site and read the numerous questions and answers that have been posted.

But roughly speaking, we trust institutions in proportion to how we think they have responded to other crises. If people have a negative memory of how the federal government dealt with, say, Hurricane Katrina, it can affect how they think the government will respond to another crisis. That memory informs our reaction to the new event.

Weber, the Columbia professor, offered a different idea for coping with ourselves: "There are traders who have told me that when they start feeling panicky, they actually stop actively trading and call someone to give them advice. They build their own safety systems to overcome impulse reactions."

For Diane and Steve Rothman, a retired couple from Fairfax County, that's Marjorie Fox, a financial planner. "My human instinct several times has been to call Margie and to tell her to put all the money in oil futures. Let's speculate. Let's take that ride," Steve Rothman said. But he knows that Fox wouldn't buy into the idea and that she would talk him out of it. Fox has diversified their assets across a variety of investments, from stocks to bonds and beyond, just like the textbooks say.

When I had Fox on the phone, I asked her about all this herd selling.

"Should you sell if everyone else is selling?" I asked.

She said, "No. I wouldn't do that."

I said, "Why? Everyone is selling."

She said, "Because at some point, everyone will be buying."