Financial Crisis Illustrates Influence of Emotions, Behavior on Markets

The past month of corporate failures, government rescues and stock market gyrations has visibly shaken the confidence of Wall Street tycoons and ordinary investors alike.

Some researchers say it has also been rich with examples of the ways in which shaken confidence -- and other psychological and behavioral factors -- affects individuals' financial decisions and the economy as a whole.

Santa Clara University economics professor Hersh Shefrin said several factors have led to the current crisis: investment banks that excessively leveraged their debt, homeowners' finances stretched beyond their means and weak government regulation.

"But overarching all of those pieces is psychology," Shefrin said. "If it weren't for psychological issues, even with all of that in place we wouldn't have the fiasco that we have now."

Shefrin studies behavioral economics, a field that's developed over the past several decades on the border between economics and psychology. Traditional economics assumes that people make rational economic decisions in an attempt to maximize the money they can earn. Behavioral economists, in contrast, study the ways in which people's emotions, cognitive errors and other psychological factors influence their decisions.

Long a subset of economic theory, behavioral economics has begun to move to center stage in recent years. In 2002, Daniel Kahneman, a psychologist with no formal economics training, won a Nobel Prize in economics for his work in the field.

The principles of behavioral economics can be seen all over the current crisis, Shefrin and others say, from the overly optimistic lending practices that led to the crisis to the current fluctuations of the stock market.

People's tendency to see the future through rose-tinted lenses is so well established that psychologists have a name for it: optimism bias.

In one classic study, psychologist Neil Weinstein asked college students to rate whether they were more or less likely than other students their age to experience 42 various events over their lifetimes. Some events were positive, such as purchasing a house; others were negative, such as getting a divorce; and some were neutral.

Weinstein found that students, on average, thought that they were more likely to experience positive events than other students (that was true for 15 of the 18 positive events), but less likely on average to experience negative events (this was true for 22 of the 24 negative events.)

Psychology professors repeat this study in their classrooms to prove the point that we all think we're going to do better than our peers, and we can't all be right.

This rosy outlook can be dangerous when translated into the housing market, Shefrin said.

"I think that what would have happened is if investment professionals were less overconfident, then they would have better assessed the risk of holding such huge amounts of their portfolios in mortgage-backed securities, given the risk of being in a bubble," he said. "And you would have had less lax lending. Homeowners who took out those loans simply wanted the American dream -- they bought during a bubble on the assumption that housing prices are going up and will continue to go up."

Growth in the stock market --or housing market -- only serves to increase people's overconfidence, says Shefrin's colleague Meir Statman, since people tend to attribute their gains or losses to their own skill rather than the vagaries of the market.

In a recent study, Statman found that the volume of stock trading tends to go up in the weeks and months following an increase in the stock markets, while volume goes down after a decrease.

"People attribute increases to their own great skills," Statman says, and so become even more active investors.

Meanwhile, the stock market's erratic performance -- in the wake of the mortgage-crisis-tied collapse of several banking giants -- demonstrates another aspect of behavioral economics, said psychology professor Elke Weber of Columbia University.

No doubt it's been an eventful week, Weber said, but people have known for a while that the market fundamentals were bad. "If you look at the huge fluctuations in the market we've had in the last week [...] it's vastly larger than the change in actual information," she said.

That's because investors tend to make decisions based on the most recent information they have -- not necessarily the most important. For example, investors overreacted as news trickled out about the fate of the congressional financial rescue plan, Weber said.

"People make decisions based on very recent feedback," she said. "Not what's happened in the last 10 years, but what's happened in the last day."

Finally, the public's reaction to the $700 billion government rescue plan illustrates another psychological principal: The degree to which people are willing to forsake financial gain in order to punish wrongdoers.

In a classic study called the ultimatum game, psychologists give one participant (call him person A) some money, and ask him to split it with another person (call him B). A can divide the money any way he chooses -- he can split it evenly, take 75 percent, or take all of it, for example. But if person B refuses the deal, then neither participant gets to keep any money. Researchers have consistently found that if A offers B less than about 30 percent of the pot, then B will refuse the money in order to punish A for the perceived unfairness -- even though this means that B will also walk away with nothing.

That experiment, writ large, explains why so many members of the public -- and their congressional representatives -- were reluctant to support a bailout of Wall Street banks, even though experts including Fed chairman Ben Bernanke and Treasury Secretary Henry Paulson told them it was necessary to protect their own financial futures.

"The public wants to punish the people who screwed up, and is willing to take a financial hit to do it," says social psychologist Jennifer Lerner, the head of Harvard University's Decision Science Laboratory.

Lerner studies how emotions like anger, fear and sadness influence people's decision making, including economic decisions. She's found that when people are fearful they are more risk-averse, but when they are angry they are more willing to take risks, including financial risks.

In the case of the bailout, people had someone to blame for the financial mess -- Wall Street banks for example -- and so were more angry than sad, and more willing to take a financial risk to punish the wrongdoers.

Overall, says Shefrin, what behavioral economists emphasize is that the economic errors people make aren't random, and the decisions they make aren't necessarily rational. Instead, they're based on common psychological factors, biases and cognitive errors.

So rather than cancelling each other out in the way that they would if people were rational investors -- if one person made a mistake and undervalued a stock, another would swoop in to buy it and the price would return to the correct level -- investors simply compound one another's errors.

"A lot of times those errors won't coalesce in a way that brings disaster," Shefrin said. "But sometimes they will."

---- By Lea Winerman, Online NewsHour