

# Booms, busts and investor psychology

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## Key points

- Investment markets are driven by more than just fundamentals. Investor psychology plays a huge role and helps explain why asset prices go through periodic booms and busts.
- The key point for investors to be aware of is the role of investor psychology and the influence of psychological illusions. The best defence is to be aware of past market cycles (so nothing comes as a surprise) and to avoid being sucked into booms and spat out during busts. If an investor is looking to trade they should do so on a contrarian basis. This means accumulating when the crowd is panicking, lightening off when it is euphoric.

## Introduction

Up until the 1980s the dominant theory was that financial markets were efficient - in other words, all relevant information was reflected in asset prices and in a rational manner. While some think it was the global financial crisis with its collapse in credit markets and consequent 50% fall in global shares that caused faith in the so-called Efficient Markets Hypothesis (EMH) to begin unravelling, this actually occurred in the 1980s. In fact it was probably the October 1987 crash that drove the nail in the coffin of the EMH as it was virtually impossible to explain why US shares fell over 30% and Australian shares fell 50% in a two-month period when there was very little in the way of new information to justify such a move. It's also hard to explain the 80% 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 share market volatility is way too high to be explained by investment fundamentals alone. Something else is obviously at play, and that is investor psychology.

## Investor psychology

Several aspects of investor psychology interact in helping drive bull and bear phases in investment markets, including individual lapses of logic and crowd psychology.

## Individuals are not rational

Numerous studies by psychologists have shown that people are not rational and tend to suffer from various lapses of logic. The most significant examples are as follows:

- **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 he or she is likely to expect that it will remain so. Once a bubble gets underway, investors' emotional commitment to it continuing steadily rises, thus helping to perpetuate it.

- **Overconfidence** - people tend to be overconfident in their own investment abilities. This is particularly the case for men.
- **Too slow in adjusting expectations** - people tend to be overly conservative in adjusting their expectations to new information and do so slowly over time. This partly explains why bubbles and crashes in share markets normally unfold over long periods.
- **Selective use of information** - people tend to ignore information that conflicts with current views. In other words they make their own reality. This again helps to perpetuate a bubble once it gets underway.
- **Wishful thinking** – people tend to require less information to predict a desirable event than an undesirable one. This may partly explain why asset price bubbles normally precede crashes.
- **Myopic loss aversion** – people tend to 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) relative to 'safer' assets such as cash or government bonds.

## The madness of crowds

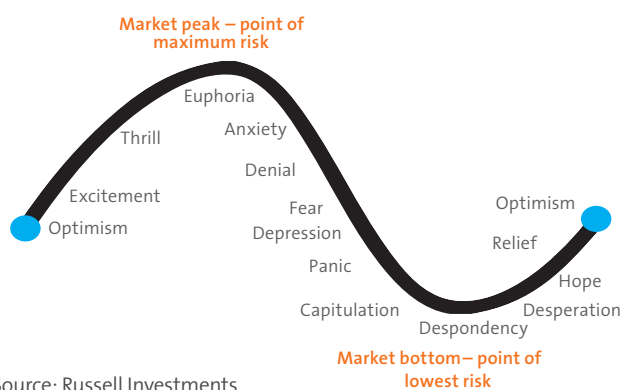
As if individual irrationality is not enough, it tends to get magnified and reinforced by 'crowd psychology'. Investment markets have long been considered as providing examples of crowd psychology at work. Collective behaviour in investment markets requires the presence of several things:

- **A means where behaviour can be contagious** – mass communication with the proliferation of the financial media both in print and electronic form are a perfect example of this. More than ever, investors are drawing their information from the same sources, which in turn results in an ever-increasing correlation of views amongst investors, thus reinforcing trends.
- **Pressure for conformity** – interaction with friends, monthly performance charts, industry standards and benchmarking, all help result in herding amongst investors.
- **A precipitating event or displacement** that gives 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 of this on the positive side. The demise of Lehman Brothers and related events setting off investor panic is an example of such a displacement on the negative side.
- **A general belief that grows and spreads** – e.g. share prices can only go up or alternatively shares are a poor investment – this helps 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 such lapses by crowd psychology goes a long way in explaining why speculative surges in asset prices develop (usually after some good news) and how they feed on themselves (as individuals project recent 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, which was 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. So 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 then 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 which eventually gave way to capitulation and despondency in late 2002 and early 2003. By 2007 the focus of investor euphoria had reappeared but was focused on credit, the US housing market and commodities. At the depths of the global financial crisis in early 2009, this again turned to capitulation and despondency with respect to most growth-oriented investments, which in turn helped set the scene for the recovery in investment markets over the last two years as the global financial crisis subsided and economic data started to improve. There are several points to note from all this. Firstly, 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, e.g. strong economic growth and easy monetary conditions. Secondly, 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 who wish to buy (or sell) have done so, meaning it only requires a small amount of bad news (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.

### What does this mean for investors?

1. The first thing investors need to do is 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. Investors also need to recognise that not only are investment markets highly unstable, they can also be highly seductive. The key here is to be aware of past market booms and busts, so that when they arise in the future one does not overreact.
2. Investors need to recognise their own emotional capabilities. In other words, investors must be aware of how they are influenced by lapses in their own logic and crowd influences.
3. Investors ought to choose an investment strategy which can withstand inevitable crises while remaining consistent with their financial objectives and risk tolerance.
4. Investors should essentially stick to this broad strategy even when surging share prices otherwise tempt them to consider a more aggressive approach, or when plunging values might suck them into a highly defensive approach.
5. Finally, if an investor is tempted to trade they should 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 investors need to recognise contrarian investing is not fool-proof – just because the crowd looks irrationally bullish (or bearish) doesn't mean it can't get more so.

### Concluding comments

The bottom line is investment markets are driven by more than just fundamentals. The key point for investors is to be aware of the role of investor psychology and the influence that psychological illusions can have on both the market and themselves. Finally, some may be thinking that if investment markets are not efficient and prone to swings from irrational pessimism to irrational exuberance, how can we rely on them to best allocate scarce resources throughout the economy? The answer is simple - for all their faults, free capital markets are far better at this task than centralised government bureaucracies.

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