Your Brain during a Stock Market Crisis

"The most important quality for an investor is temperament, not intellect." – Warren Buffett"

If you have ever taken a university-level course in finance, you probably were taught that investors always act rationally and in their own best interest. This is one of the most important and pervasive assumptions in classical financial economics, and it is also quite mistaken. Researchers in the field of behavioral economics have convincingly demonstrated that investors are usually driven not by rational calculation, but by fear, greed, illusions of control, overconfidence, and other irrational biases. Unfortunately, these irrational tendencies often cause significant harm to investors' investment results.

The source of this irrational investing behavior is both psychological and physiological; given the way the mind and brain have co-evolved, we humans are hard-wired to react viscerally and to behave in an emotional way. A crisis situation where there is an elevated probability of imminent and significant financial loss exacerbates this behavior. The coronavirus pandemic is a textbook example of this type of situation.

Who is in charge here?

If investors were perfectly rational, their investment decisions would mostly be made in a part of the brain known as the prefrontal cortex. This area of the brain is charged with controlling emotions, predicting outcomes, and making rational "executive decisions."

Unfortunately for investors, the prefrontal cortex is not in charge in times of high stress. When we are in crisis mode, a more primal area of the brain known as the amygdala is running the show. The amygdala is responsible for fight-or-flight responses, controlling some aspects of memory, and emotions like fear, anger, and aggression. So, when investment decisions are made during times of crisis, they are made by the fickle and emotional amygdala rather than the rational prefrontal cortex.

The amygdala served a crucial purpose in the evolution of humans. When a prehistoric man heard a rustling in the tall grass, he did not rely on his prefrontal cortex to calculate the probability that it was a lion; his amygdala took charge and he quickly raced up the nearest tree. In primitive crisis situations, the instinctive and intuitive reactions of the amygdala were more useful than the cold calculation of the prefrontal cortex – as they still are today. The downside of instinctively but unnecessarily scrambling up a tree is far smaller than the downside of mistakenly concluding that there is no lion in the bush.

During financial crises, however, having the amygdala in charge is often counter-productive. Behavioral psychologists have demonstrated that the fear of financial loss activates the fight-or-flight response in the amygdala in the same way that physical danger does. The problem is that, in a modern investment context, the financial downside of an emotional flight reaction is often far greater than that of a calm, rational response.

The coronavirus pandemic provides us with a prime example of how this emotional response can damage your portfolio. As people continue to get sick and the news headlines become more frightening, the market drops in response and the amygdala senses danger and engages your primitive flight instinct. You may end up doing the modern equivalent of running up into a tree: selling your stocks without stopping to ask what price you will receive for them or how long the danger will last. In this situation, the calm, long-term approach of the prefrontal cortex would allow you to see that selling after stocks have already plummeted is usually not in the interest of your long-term financial health.

Elephants and their riders

One useful way to think about these two competing portions of an investor's psyche is through a clever analogy provided by psychologist Jonathan Haidt in his book The Righteous Mind. For Haidt, the two parts of the mind are like an emotional elephant and the rational man riding the elephant. The rational part of our mind (the rider) likes to believe it is in charge of the emotions, and in many circumstances it is. But when a crisis erupts, emotions take charge; the elephant revolts against the rider, and in this conflict the primitive brute strength of the elephant will win every time.

Back in January of this year, the relative calm of the long bull market allowed most riders to keep the elephant on the right path. But things changed when the pandemic arrived. When the fear of being infected is simultaneously compounded by the fear of losing money, the primitive, emotional elephant of the amygdala springs into action; some riders lose control, and the risk of making regrettable investment decisions soars.

Unfortunately, you cannot eliminate these emotional tendencies from your mind. The good news is that being educated on these behavioral biases will help. The rider can be made aware of the emotional tendencies of the elephant and can set up safeguards ahead of time to protect against those dangerous moments when the primal instincts of the elephant can do the most damage. When it comes to finances, establishing a sound set of rules before you begin investing is a step in the right direction, but hiring a qualified advisor with a detailed written plan is probably the best way to keep your elephant on the right path.

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H|I|G HERITAGE INVESTMENT GROUP

Main Office/Mailing
2480 N.E. 23rd Street, Pompano Beach, Florida
33062 Phone: 954.785.5400 Fax: 954.933.0966

Tampa Office
115 South Fielding Avenue, Tampa, Florida 33606
Phone: 813.258.1759 Fax: 954.933.0966

www.heritageinvestment.com