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Forget Logic; Fear Appears to Have Edge

By VIKAS BAJAJ

The technical term for it is “negative feedback loop.” The rest of us just call it a panic.

How else to explain yet another plunge in the stock market Tuesday that sent the Standard & Poor’s 500-stock index to its lowest level in five years — particularly in the absence of another nasty surprise?

If anything, the markets should have been buoyed by the Federal Reserve saying it would shore up another troubled corner of finance by lending money directly to companies. Stocks did open higher, but then quickly tumbled as rumors swirled about the viability of big financial firms like Morgan Stanley and the Royal Bank of Scotland.

Anybody searching for cause-and-effect logic in the daily gyrations of the market will be disappointed — even if the overarching problem of a crisis of confidence in the global economy is now becoming clear.

Instead, the market has become a case study in the psychology of crowds, many experts say. In normal times, it runs on a healthy mix of fear and greed. But fear now seems to rule, with investors often exhibiting a Wall Street version of the fight-or-flight mechanism — they are selling first, and asking questions later.

“What’s happening is people are crawling into a bunker and pulling an iron sheet over their heads because they think the sky is falling,” said William Ackman, a prominent hedge fund manager in New York.

And that bunker is getting very crowded, so much so that some analysts are starting to suggest the markets are showing signs of “capitulation” — another term of art to describe what happens when even the bullish holdouts, the unflagging optimists, throw up their hands and join the stampede out of the market.

Fear can be seen at every turn — in headlines raising questions about another Great Depression, and in the crowds gathered around office televisions to track stocks or to parse the latest pronouncements from the Federal Reserve chairman, Ben S. Bernanke, or the Treasury secretary, Henry M. Paulson Jr.

Even James Cramer, the voluble and long-bullish host of an investing show on CNBC, advised investors to sell some stock during appearances on the “Today” show Monday and Tuesday mornings.

To some, signs of capitulation can be read as an indicator that the bottom may be near. Indeed, Sam Stovall, chief investment strategist at Standard & Poor’s Equity Research, is among those who say the market may be close to a bottom.

In addition to his analysis of the market, he was swayed by the numerous telephone calls he has received in recent days from professional acquaintances and his sister-in-law, all saying they are getting out of stocks.

“More and more people are doing that and selling out,” Mr. Stovall said.

The opposite of capitulation, of course, is investing at the height of a bubble. One oft-cited sign of the housing market's top: when dinner parties are dominated by stories about fast profits on flipped condominiums.

During the dot-com boom in the late 1990s, it seemed everybody and their grandmothers were piling into stocks. Now they are bailing out. Tuesday was the fourth consecutive day that the S.& P. 500-stock index registered a decline of 1 percent or more. The last time that happened was October 2002, when the index reached its lowest point during the bear market that started in 2000. The S.& P. is now down 36 percent from its peak a year ago, almost to the day, on Oct. 9, 2007.

Another barometer of panic: volatility, reflected in the so-called Fear Index (or the VIX), which tracks options trades that investors use to protect against future losses. On Tuesday, it climbed to its highest level since the 1987 stock market crash.

Fear is an immensely powerful force, perhaps more so than greed, said Andrew W. Lo, a professor at the [Massachusetts Institute of Technology](#) who has studied investor behavior.

Scientists who have studied the brain function have found that the amygdala, the part of the brain that controls fear, responds faster than the parts of the brain that handle cognitive functions, he said.

"Fear is a much stronger motivational force," Mr. Lo added. "The loss of \$1,000 has a much bigger impact than the gain of a \$1,000."

He cites a series of groundbreaking experiments in the 1970s by psychologists Daniel Kahneman and Amos Tversky. In one test, they asked students to choose between a sure bet of \$3,000, or an 80 percent chance of winning \$4,000 (meaning there was a 20 percent chance of winning nothing). Most students said they would take the \$3,000.

The same question, framed differently, asked them if they would rather lose \$3,000 or accept an 80 percent chance of losing \$4,000 (with a 20 percent chance of losing nothing). In this case, they said they would take the riskier bet.

In other words, they were willing to take a bigger risk to avoid losing money than they were when they stood to make more money.

Those instincts seem to be taking over.

At this point, any spreadsheet analysis of underlying and intrinsic values of stocks becomes meaningless, and concern for preserving wealth overrides the desire to grow it — what some may call greed.

"With negative emotions we tend to have a desire to change the situation," said Ellen Peters, a senior scientist at Decision Research in Eugene, Ore. But "when things are good there is not much desire to change."

That perhaps explains why investors are willing to earn virtually no return in Treasury bills just to be assured that they will get their money back, rather than investing in short-term corporate debt that offers a better return but carries some risk. Investors were reminded of that risk after [Lehman Brothers](#) sought

bankruptcy protection last month.

Even banks, which make money by lending to businesses, consumers and each other, are hoarding cash. That is why the Federal Reserve said on Tuesday that it would buy commercial paper, the short-term loans issued by companies and banks.

If the market is indeed close to the bottom, history suggests any rally in the next few weeks will probably be big. Since World War II, Mr. Stovall estimates stocks have recouped about a third of their bear market losses in the first 40 days after the market hits bottom.

But enough investors have to first be persuaded that the economy and housing market will begin recovering soon. Another major test will be third-quarter corporate earnings announcements that will trickle out in the next three weeks.

Perhaps the most important indicator will be the credit markets: Investors will regain confidence when they believe financial firms are adequately capitalized and money is flowing more freely through the financial system.

Mr. Ackman, the hedge fund manager who has been vocal about his bearish views of some financial companies in recent years, said it is hard to precisely time the market. But, he added, "I do think that stocks are getting extremely cheap."

David Bertocchi, a portfolio manager for Baring Asset Management in London, echoed that sentiment, saying he was beginning to increase his stake in certain companies.

He is taking advantage, he said, of panicked selling by hedge funds that have to pay back loans to their brokers. "That's what drives markets to attractive levels," he said.

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