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The Psychology of Investment

Behavioral economics uses psychology to explain the dynamics of production and consumption. This approach derives from the assumption that the market is driven by incentives, and that many buying decisions are influenced by emotion and irrational thinking.

This approach in studying the mind and how it affects the depletion of bank balances allowed a bigger role for psychology in economic analysis. The increasing emphasis of behavior in the law of supply and demand is heralded by the awarding of the Nobel Prize for Economics in 2002 to Daniel Kahneman, a doctor of psychology and a non-economist. He was cited for his studies on judgment and decision-making as they affect economic decisions. One recent book of his, "Thinking, Fast and Slow" delves on the two types of analysis, the intuitive and the calculating. Economic decisions, like the purchase of the car or the selection of dessert, use either slow or fast thinking.

Behavioral economics is not really new. The dismal science has long ago understood the effect of feelings on Homo Economicus, the hypothetical construct of the "economic man", a rational investor/consumer guided by perfect knowledge and evaluation of prices and markets. Prior to the ascendance of the behaviorists, economic concepts already incorporated feelings, as in the law of "diminishing marginal utility" which looks at the declining enjoyment for the consumer that the sixth pair of shoes brings compared to the first.

One psychological phenomenon from last year's (up to this year's first quarter) continually rising stock and property prices on the investor is a higher propensity to consume. The happy investor is apt to spend money he doesn't really have yet, simply because he feels richer with his paper profits. The green numbers become his go signal to step on the accelerator of his spending motor.

Economists explain the increase in consumer spending during a bull market as the "wealth effect." When paper (and still unrealized) profits accumulate in one's stock position, the exuberant, though irrational, feeling of wealth sets in, even when the money is not yet in the bank. This leads to economic exuberance and the consumption of luxuries like Jaguars, condo units, couture clothes, jewelry, and foreign trips. The feeling of being wealthy can drive consumption, fueled by credit card spending.

The false sense of affluence is buttressed by the "herd mentality." When a new record is reached by the index, as when breaching the magical 8,000 mark, wasn't there a mooing of the herd on the floor?

The herd mentality, sometimes also called "groupthink", reminiscent of George Orwell's "1984", is a self-reinforcing mechanism that also affects stock picking. There is a "hot" stock which seems to be surging with the buying spree. This stampede may last all of three days after which the stock settles back to its old sleepy level accompanied by a declining volume—where did the herd go?

There is too a touristy feeling in the market. Any traveler to a new city, say London or Rome, will be accosted by a costumed barker selling the city tour on a hop-on-hop-off basis. The trading mentality of

getting on and off a stock price is not always well-timed. Unlike the city tour, the stock picker's on-and-off ride does not even offer photographs that can be posted on FB.

What if the stock market is volatile and on a downward trend, does the investor now feel poorer and experience an opposite "poverty effect"? If the investor is trading on margin, the poverty may be more real as his position is sold off and losses kick in faster.

Poverty in the context of emotions is a totally different from real deprivation, a state where even basic goods like food and taxi fare cannot be purchased or consumed. Still the poverty effect strikes both real and imagined reduction of disposable income.

Signs of the poverty effect, whether psychological or real, are hard to miss.

Indifference to good news is pronounced. There is little appreciation for statements on the drivers of growth remaining intact and unappreciated. Property marketers use the malls to give away brochures on unsold inventory "for investment." Pre-selling of condo units on a three-year delivery are not stoking interest, as seen from their flat prices, even with interest-free installment offers.

Days' receivables of supplier companies are stretching. Even large corporations hang on to cash and extend their payments to suppliers like security services and landscape architects. This postponement, if not deep discounting, of bills creates the illusion of having more cash on hand from de facto suppliers' credit. The poverty effect also applies to companies after all.

Purchases of blazers, bespoke jeans, trips, and gadget upgrades are postponed.

Preventing the poverty effect in taking root entails showing more than GDP numbers and the usual economic metrics like inflation within the range, although in the upper levels. There is an emotional component similar to a recently wealthy individual feeling uncomfortable he will continue to live in his ritzy houses. (Is his boxing career over?)

Anyway, there's nothing really wrong with feeling a little poorer. It may turn cash (and savings) into a viable portfolio component again. Still, it is consumption and the feeling of wealth that truly spurs the economy.

It is good to remember that even when the market is down (or at least the stocks that you own) that it is not what you lost but what you still have left that counts. For the "buy and hold" followers of the philosophy of Warren Buffet, declining stock prices are just paper losses. But it is also possible that these stocks can just be paper, and nothing else.

Even optimists though have stopped advising the strategy of "averaging down" or buying the same stock at declining prices. The poverty effect takes hold when it is time to cut losses and sell the stock. Then a glimpse of real poverty may be like waking up from a nightmare and then realizing you weren't even sleeping.

The psychology of the market is not all in the mind. It's alive. To paraphrase Mufasa in the "Lion King", the mental rules prevail—they live in you/they live in me/they're watching over/everything we see.

And when the market comes off its record highs, it's not the lion but the cash that's king…even when there's less of it than before.

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