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TALKING BUSINESS; The Worst Investors? Humans

By JOE NOCERA

I know I'm jumping the gun a little here, but do you realize that the 20th anniversary of the Crash of '87 is right around the corner?

I'll never forget that day. It was Monday, Oct. 19, and I was in Boston, working on a story about Fidelity Investments for Esquire magazine. The article was the brainchild of Esquire's editor then, Lee Eisenberg, who had become fixated on the country's obsession with the bull market that had begun in 1982.

There is something new going on, I remember Lee saying, and he was right. Over the previous 15 years, an enormous transformation had taken place: with the rise of discount brokers, the elimination of fixed commissions, the introduction of individual retirement accounts and a hundred other things, the stock market had become democratized. There had been bull markets before, but this was the first in which a broad swatch of the great middle class had its savings in the stock market. We had become investors, by George, and we were all going to get rich.

Or were we?

There was an overwhelming sense of foreboding that Monday morning. After a summer of tremendous gains, the Dow Jones industrial average had dropped 11 percent the week before -- its worst week since World War II. All weekend long, the Fidelity call centers had been flooded with calls from panicky investors.

When the bell finally rang on Monday, it was worse than anyone could have imagined. The market started spiraling downward and never really stopped; by the time it closed, the Standard & Poor's 500-stock index had lost 23 percent, making it the single worst day in the history of the American stock market. It was like "watching a Fellini movie, except that I was in it," the investment adviser John Spooner would later write in *The Boston Globe*. I spent most of the day at a Fidelity retail office, where so many investors had crowded outside to watch the electronic tape that traffic was blocked. We didn't talk to each other; we just stared at the window. I remember feeling paralyzed.

Jason Zweig has his own memories of Black Monday. A few months earlier, he had gotten a job at Forbes -- "as a cub reporter" -- and he recalled the entire staff staring at the one television screen in the office, in a state of utter shock. But he also remembers something else: "I kept asking myself, 'How did this happen? What could drive this?' It wasn't a question anybody had a good answer to." In the subsequent 20 years, at Forbes and then at Money magazine, Mr. Zweig has tried to find an answer to that question. In his new book, "Your Money & Your Brain" (Simon & Schuster), he's as close as anybody's likely to come.

"There is a story in the book about Harry Markowitz," Mr. Zweig said the other day. He was referring to Harry M. Markowitz, the renowned economist who shared a Nobel for helping found modern portfolio theory -- and proving the importance of diversification. It's a story that says everything about how most of us act when it comes to investing. Mr. Markowitz was then working at the RAND Corporation and trying to figure out how to allocate his retirement account. He knew what he should do: "I should have computed the historical co-variances of the asset classes and drawn an efficient frontier." (That's efficient-market talk for draining as much risk as possible out of his portfolio.)

But, he said, "I visualized my grief if the stock market went way up and I wasn't in it -- or if it went way down and I was completely in it. So I split my contributions 50/50 between stocks and bonds." As Mr. Zweig notes dryly, Mr. Markowitz had proved "incapable of applying" his breakthrough theory to his own money. Economists in his day believed powerfully in the concept of "economic man"-- the theory that people always acted in their own best self-interest. Yet Mr. Markowitz, famous economist though he was, was clearly not an example of economic man.

Neither are the rest of us. That's the thing about investing: we may not have invented portfolio theory like Mr. Markowitz, but most of us have some smarts, and we know, absolutely, what we are supposed to do with our money. We're supposed to diversify, shut out all the white noise of the market, rely mainly on low-expense index funds, sell when stocks are high and buy when they are going down. We should avoid the herd instead of becoming part of the herd. That what economic man would do.

But do we do that? Hardly. When it comes to investing, most of us simply don't act rationally. Small investors spend hours on chat boards, where the herd mentality is fiercest. They can't bring themselves to sell losing

positions, even when the stock is still going down. They bet everything on one or two high-risk stocks. I do not exempt myself from this behavior: a decade after the Crash of '87, I was loading up on tech stocks during the Internet bubble, even as I was writing article after article about how the bubble couldn't possibly last.

Having watched the way investors have behaved since the Crash of '87, I've come to believe that most human beings are simply not hard-wired to be good investors. In the 1990s, a new kind of economics arose, called behavioral economics, which tried to show that investors weren't so rational after all. So I can't deny that one of the reasons I like Mr. Zweig's book so much is he provides, at last, a scientific basis for this theory. It turns out that there is a new discipline called neuroeconomics, which combines biology, psychology and economics and tries to understand why we make the often foolish financial decisions we make.

The central finding, as Mr. Zweig put it, is that "the brain is not an optimal tool for making financial decisions." The part of our brain that tells us to act like rational investors tends to be completely overtaken by much more powerful emotional impulses -- impulses, Mr. Zweig writes, "that make us human."

He's got a million examples. "Humans," he writes, "have a phenomenal ability to detect and interpret simple patterns. That's what helped our ancestors survive the hazardous primeval world, enabling them to evade predators, find food and shelter and eventually to plant crops in the right place at the right time of year." But, he adds, "when it comes to investing, our incorrigible search for patterns leads us to assume that order exists where it often doesn't."

The bogus science of technical analysis comes out of this deep human trait -- investors search for trends that are consistent and repeatable (even though they're not). So does our need to try to predict where the market is going -- something no one can possibly know. "As soon as a stock seems to conform to a pattern that has made money before, an 'I got it' effect kicks in, making investors feel sure they know what's coming next," Mr. Zweig writes. But of course they don't.

Virtually every mistake investors make has to do, in one way or another, with the way our brain has evolved. Putting far too much of our retirement portfolio in the stock of the company we work for? Neuroeconomic

experiments have shown that when people put money in foreign markets, the amygdala -- "one of the brain's fear centers" -- kicks in. On the other hand, investing close to home -- or, better yet, in the company you are most familiar with, your own -- "generates an automatic feeling of comfort."

How about understanding what our real tolerance for risk is? Mr. Zweig makes the usually overlooked point that our risk tolerance is not a fixed thing, but changes from day to day, even hour to hour, depending on our mood. Indeed, research has shown that the way we think about risk often depends on how others have framed the question for us. Amazingly, for instance, people tend to be more sanguine about risk when it is expressed as a percentage (10 percent, say) than when it is expressed as a frequency (one out of 10).

Despite everything, Mr. Zweig remains an investing optimist. He still thinks that people can learn to resist their emotions, buy those low-cost index funds, step away from the herd and all the rest of it. He gives plenty of advice along those lines. It's not novel advice -- David F. Swensen, the great investor who manages the Yale University endowment, gave pretty much the same advice in the book he wrote last year, "Unconventional Success." But it's right.

I came away from Mr. Zweig's book feeling just the opposite, though: that there is really not much hope that we're ever going to get the hang of investing. Humans are emotional beings, and that is always going to get in the way. What sets apart investing geniuses like Warren Buffett is precisely their ability to ignore their emotions --or, perhaps, to use them differently than the rest of us do.

"I don't think they ignore their emotions," Mr. Zweig said. "I think they turn them inside out. When they feel fear, they don't act on it. They examine it. They say, what should this feeling tell me? It should tell me that prices have gone down so values have gone up." So they buy stocks while the rest of us are selling.

Then again, maybe there's a much simpler explanation. As our interview was winding down, Mr. Zweig told me a story -- "I think it might even be true" -- about Charles T. Munger, the Los Angeles lawyer best known as Mr. Buffett's sidekick at Berkshire Hathaway. "A woman was sitting next to him at a dinner party in L.A.," Mr. Zweig said. "She turned to him and said, 'You're Warren Buffett's partner, and a great investor. Tell me, what is your secret?'"

Mr. Munger looked up at her. "I'm rational," he said. Then he went back to his dinner.