Reflections on the Downturn

Let’s imagine for a moment that on your daily walk to work, your normal route takes you past a pawn shop that is known to display expensive jewelry. Over the past couple of days, you’ve noticed that the jewelry on display has been marked down—for reasons that you don’t really understand. All you know is that, in the past, these times when the jewelry went on sale were quite temporary and, in fact, in the past the prices were far more likely to go up than to go down.

The store also buys jewelry from the public, and over the same recent time period, the prices it is willing to pay have been declining as well.

The question is: would you pick this time to sell some of your own jewelry, or to buy some while it’s temporarily on sale?

You can apply this same thought experiment to on-sale items at the clothing rack or in the grocery store, and the answer is always the same: your inclination would be to buy when things are on sale, and to sell (if you happen to have something) whenever the prices go back up.

The peculiar thing about this thought experiment is that whenever you’re talking about jewelry, or clothing, groceries or pretty much any everyday item in the marketplace, the response is obvious. But when we’re confronted with exactly this same situation regarding stocks, ETFs or other investments, the immediate inclination is exactly the opposite.

Why should that be? Psychologists have had a field day exploring the ideas of herd mentality and recency bias and a lot of other mental shortcuts (psychologists call them “heuristics”), but nobody has ever managed to explain why our instinctive reaction to price movements in investments should be different from our instinctive reaction to virtually everything else in the global marketplace. We know that fear plays a role, but how rational is that fear when every market decline in history has been followed by subsequent record highs? We know that fluctuations in our net worth are tied to our sense of well-being, but why should we feel less confident when the paper value of our holdings is 2-3% lower today than it was yesterday? Do we feel that much more confident when the markets are UP 2% or 3%?

Years ago, after Microsoft stock had risen from practically zero to astronomical heights, a financial journalist interviewed a few people who had become wealthy by holding on to their Microsoft investment for two full decades. The first surprise was how few of them there were; many people had been given stock grants during the company’s early years in business, and others had invested in this hot company with a promising new operating system. But most of them had cashed out at the first, or second, or third dip, long before the real money was made.

The second surprise was how all of these now-wealthy stockholders told the same story: that there were many times when they had to grit their teeth and avoid the temptation to sell the stock of a company that was increasingly dominating desktop software. Every bump in the road was, to them, a strong sell signal, which required a certain fortitude to hang on.

The lesson in all this is that all of our brains are wired to be dysfunctional investors. Now that the markets are becoming unpredictable and stocks are going on sale, all the tendencies to make bad decisions are being triggered. If the same thing were happening at the grocery story or in that pawn shop display, we’d all be cheering this nice (albeit temporary) opportunity. The fact that we are not cheering tells us a lot about ourselves.