

# Invest your Confidence

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Another way to look at financial worries is to consider the current panic in the market and the crash of prices as being the flip-side of a bull market bubble. Crashes may sometimes have greater acceleration than the building of bubbles. People suffer their losses more than they enjoy their gains. Classical economists like to believe in a rational efficient market, but there are clear "emotional" components to the sudden rise and fall of stocks—and to the enormous volatility.

How can cognitive therapy help us understand this and how can we reduce our catastrophic thinking about the market and the coming (existing ) recession?

1. As people begin to panic they sell off rapidly, but there are few buyers because everyone (except Warren Buffet) is afraid. This creates "cost cascades" as more and more people are selling , chasing lower and lower prices. This further adds to the panic.
2. Panicked buyers and sellers see linear negative trends, they view these trends as accelerating, they discount positive information, and they catastrophize the worst case scenario. This is similar to how people think when they have an anxiety disorder. They search for danger, focus on it, and escape and avoid. They may be right or they may be wrong, but similar patterns of cognitive biases are operating.
3. This panic selling leads to more and more "buzz" about how bad things are, further driving down prices. This is the social contagion of bubbles and panics—and creates an amplification of the perception of risk. Just as Robert Shiller from Yale could use cognitive principles to understand "irrational exuberance"--- you can use many of these same principles to understand financial panics.
4. In the last sell-off a few years ago, Apple stock was selling for less than the cash on hand in the company---meaning that panic sellers and buyers were attributing no value to the product and the good reputation of Apple. They were acting as if the cash didn't have a real value. This was clearly irrational and provided a unique buying opportunity for those who could see that fundamentals and facts were being trumped by fear.
5. Panicked sellers and buyers seek out information to confirm their negative biases. Bad news is sought out, rescue plans are discounted, and people go with their emotion. This confirmation bias is a typical feature of anxious and depressive thinking. As it is, by the way, for manic expansive moods.
6. Irrational panics create opportunities for investors who see that there are fundamental values in a company---such as profits, products, and cash. These prudent and rational investors not only discount the panic in the marketplace, but they look at it as a signal to buy. As one investor told me, "Absolutely no one wants to buy anything. This may be the best time to buy"

Historically, recessions in the last 65 years have been relatively short, not too bad, and are followed by long periods of positive growth (<http://harvardbusiness.org/flatmm/hbextras/200805/recessions/>). Indeed, one can argue that recessions create more efficiency in the marketplace, clear out less productive entities and create pent-up demand. Thus, when recessions end, there is usually faster growth often accompanied by inflation. It's as if the room thermostat is erratic and need a mood stabilizing medication. Americans seem to think that recessions happen to other people. What is extraordinary is how few real recessions we have had in the last thirty years---that is, two consecutive quarters of negative growth. Recessions have been so mild and so infrequent that economists have begun to define recessions in loose terms—so that slowdowns now qualify for some as recessions.

The potential good news, if you use the past as predictor, and recognize that panic means that

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people may be overvaluing negative information-- is that what is salient, dramatic, and recent news—and which everyone is fearful about---may represent an exaggeration of the situation as a predictor of the future. Not that we won't have a recession or that people won't lose money, but a swing from overly optimistic to exceptionally pessimistic appraisals may reflect a new set of cognitive biases.

If anyone is interested, I am quoted in this week's Newsweek article on the psychology of fear in the financial markets:

<http://www.newsweek.com/id/163478>

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