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REASONABLE PANIC

by James Surowiecki

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After last Tuesday's stock-market rout, which sent the Dow Jones average down more than four hundred points and erased more than half a trillion dollars of market value, Wall Street analysts and reporters quickly found a culprit: China. The Shanghai stock market had plummeted almost nine per cent before the U.S. market opened, supposedly raising concerns about the health of the Chinese economy and spooking U.S. investors. Other explanations were floated as well. Alan Greenspan had given a speech the day before warning of the possibility of recession. The government reported a sharp decline in durable-goods orders, suggesting that U.S. manufacturing was slowing down, and there were discouraging numbers from the housing market. All in all, it was a day with its fair share of bad news. At first glance, however, it didn't seem like bad news that was worth half a trillion dollars. So was the whole thing just a temporary fit of hypochondria? Did investors sniffle a few times and then all decide they were coming down with avian flu?

Some of the decline can certainly be attributed to some less than rational investor behavior. The slump in the Shanghai stock market, for instance, while precipitous, was, from the perspective of the U.S. economy, a non-event. For all the talk about the integration of global markets, there is very little foreign money invested in the Shanghai Stock Exchange, thanks to government regulations. Furthermore, the Shanghai sell-off appears to have been driven not by doubts about the well-being of China's economy but by local anxieties about possible new measures designed to curb speculation—something that would make no difference to American corporations. But the sell-off dominated pre-market news on Tuesday, and so investors were effectively given the message that China's problems really were America's.

This caused problems, because, as economists have found, investors often overvalue new information, particularly when it's presented in dramatic fashion. In one famous experiment by the psychologist Paul Andreassen, investors who selected a portfolio of stocks and then saw nothing but the stocks' changing prices managed their portfolios significantly better than investors who were also given a stream of news about the companies they'd invested in. The reason, Andreassen suggested, was that the media's tendency to overplay stories led investors to place too much weight on news that turned out to be of only transient importance. This doesn’t mean that investors should be kept in the dark—indeed, markets work best when participants are drawing information from many diverse sources—but when a single story like the Shanghai sell-off captures everyone’s attention investors will often overreact. This effect is magnified by the prevalence of short-term and momentum trading in today’s stock market. If an investor thinks a piece of news has a chance of causing a sell-off, he is likely to respond by selling, too, thereby feeding the frenzy he anticipated.

“Somehow I remember this one differently.”

Some of Tuesday’s drama, then, was the result of a mild bout of investor hysteria. But it’s likely that much of it had more sensible underpinnings. While the past few years have been exceptionally good for American companies, with interest rates and labor costs low, and profits at historic highs, a host of potentially huge risks continue to loom, including the threat of terrorism, America’s huge current-account deficit, and the possibility of a slowdown provoked by the end of the housing boom. If investors collectively decided that there was a slightly greater chance of even one of these risks becoming reality, that could have provoked the market decline we saw on Tuesday.

It may seem unlikely that a small change in investor expectations could lead to such a big sell-off. But stock-market investors are trying to predict how much money companies are going to make over the next fifteen or twenty years. Over a period that long, relatively small changes in the present can have huge effects. A ten-billion-dollar company that grows at ten per cent a year for twenty years, for instance, will be, at the end of that period, twenty billion dollars bigger than if it had grown at eight per cent a year. So while big market swings in reaction to poor earnings news or bad economic data often seem exaggerated, evidence suggests that they often turn out to be justified. For instance, a new paper by the economists Borja Larrain and Motohiro Yogo that looked at U.S. companies from 1926 to 2004 found that the movements of companies’ stock prices followed changes in their expected cash flow. And a new simulation by three British economists shows that even a stock market made up of investors who are rationally adjusting their forecasts of future business cycles will generate the kinds of volatile price changes that you see in real stock markets. In other words, even when investors are sensible their collective activity is quite capable of occasionally sending the market down four per cent in a day.

It’s a mistake to read sharp declines as portents of certain doom—investors are saying that there’s a better chance of bad things happening, not that those things will happen. Although that may not be exactly comforting news, in some sense Tuesday’s sell-off was paradoxically reassuring. Academics and policymakers have been arguing for a while now that investors are foolishly indifferent to the risks facing the global economy. But last week’s sell-off suggests that in the stock market, at least, investors are all too sensitive to the many things that can go wrong. The effects of last Tuesday may have been painful, but in the long run, this is probably good news. In a risky world, it’s better to have wary investors than reckless ones.

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