Don't be a Footsie neurotic

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Neuro-economics can help you understand your reactions - and get richer, says Jason Zweig

What goes on in your brain when markets are crashing? The new science of neuro-economics - a hybrid of neuro science, economics and psychology - has begun to shed light on that question. Within 12 milliseconds, or one-25th the time it takes you to blink your eye, upsetting financial news can activate the amygdala, a structure in your brain that generates emotions like fear and anger.

That bad news can come in many forms - a headline in this newspaper, a market bulletin on your iPhone, a stock chart on a trading website, a price update or a market pundit preaching doom on television.

Plunging prices ignite the same neurons that respond to a lion's roar

Plunging stock prices ignite the same circuits in your brain that respond to the snarl of a lion. Just a flash of the red colour that symbolises a downtick is enough to excite the circuitry in your brain - and to make reflective thinking more difficult.

Merely reading the words "stock market plunges" in this sentence will raise your pulse, quicken your breathing, increase your blood pressure and tense your muscles.

If you needed to make a snap decision about a stock immediately after reading those frightening words, you would involuntarily have been propelled toward selling. Yet, because emotions can often be unconscious, you might well believe that you had made a reasoned decision at the very moment you were in the grip of a primordial fear.

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Thus the impulse to stay continuously informed about your investments in times of turmoil leads to nothing but trouble. The more frequently you check on the prices of your holdings, the more often your brain will send danger signals coursing throughout your body. Hypersensitive to risk and threat, you will find it much harder to be patient and to wait out troubles that may be temporary - whether you are a small saver or a fund manager with £1bn under your care.

Furthermore, the more often you update the prices of your stocks, the more often you will perceive "trends" that are most likely just to be illusions. The human brain is a pattern-recognition machine, and neuro-economists have shown that it takes only two iterations of a stimulus for your brain to form an automatic and uncontrollable anticipation of another repetition. Believing that you can see what is coming, you are likely to trade on that feeling of certainty - only to find, after the fact, that the news was nothing but noise.

Psychologist Paul Andreasen found that investors who received frequent updates on their holdings earned half the returns of those who got no news at all.

It is not just individual investors who are too quick to pull the trigger. One study looked at the portfolios of pension-fund managers - hypothetically putting them into the deep freeze on January 1, then comparing the performance of the "frozen" portfolios against the return their managers ended up generating with their trades in the coming year. On average, the managers' efforts to raise their performance lowered it by nearly a full percentage point.

Neuro-economics has revealed another crucial aspect of how the investing brain works: expectation is more powerful than experience. In general, anticipating a gain is much more emotionally intense than earning that gain - and expecting to lose money feels even worse than losing it turns out to be. The fear signals generated by the brain in response to the threat of a market crash are more dreadful than the pain the actual crash will cause.

Professional investors are scarcely better than amateurs at arbitraging the gap between the emotions they expect and the emotions they experience. Fund managers perennially let cash pile high during bear markets, instead of investing it in stocks as they get cheaper - testimony to the psychological toll that fear takes on them and their portfolios.

This new science offers some simple but vital lessons for amateurs and experts alike. The brain is not just the computer between our ears; it is a ball of emotion ready to burst in the worst possible way at the worst possible time. Therefore, investors should keep a brief but candid emotional diary and review it regularly. If your entries from July were honest, they would show that you were elated when the markets rose and that you were miserable in August after your holdings took an unexpected pounding.

Your September jottings turned rosy as the markets recovered, while the sub-prime fiasco of the past few weeks has darkened your mood again. The misery is no more likely to be justified than the elation was.

The greatest investors do not turn their emotions off; rather, they turn them inside out, training themselves to distrust their most obvious and natural feelings.

You should also control your cues. Just as a recovering alcoholic knows better than to trust his self-control and walk into a tavern, you should minimise your contact with anything that can fixate your attention on falling market values. Break your obsession with the market by going for a long walk, playing with your children or sneaking out to the cinema.

Stop clicking on market websites. Stay away from the Bloomberg terminal. If you read the FT, pass over the market news and spend your time on the opinion pages instead. You will surely be happier - and almost certainly end up richer.

Jason Zweig, author of Your Money and Your Brain - Become a Smarter More Successful Investor, the Neuroscience Way, is published by Souvenir Press, price £20.

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