Fear Greed and Panic

The Psychology of the Stock Market

By David Cohen

Recent years have seen a flood of books about investing. Many of them will vanish without trace. Only a few will stand the test of time. David Cohen’s book Fear Greed and Panic was originally published in hardback in 2000 as Bears and Bulls. That it has now been comprehensively revised and updated as a paperback only a year later suggests that it will find a more permanent place in the literature of the markets.

The vast majority of books about the markets emanate from the US. It is refreshing to find a book written by a British author. That said, Cohen is sometimes just as parochial as the worst from the US. However, this is a minor distraction in relation to the significant contribution Cohen has made to our understanding of the psychology of investing.

Too many of the best US books are tainted because the writer sets out to sell his or her services as a funds manager or adviser. Cohen is not an industry professional, but a highly qualified psychologist and accomplished author in that field. His book is therefore not unlike the Siegel book I reviewed in October Shares. Both are the result of a trained researcher directing his skills at the market. Siegel tackled the statistics. Cohen tackles the psychology.

A consistent theme in the feedback I get from readers who are engaged in the journey towards investing competence is that initially they gave no attention to psychology. They concentrate on the analysis and methods involved in the process. However, once they gain the basic grounding, the light comes on that psychology is the real challenge in investing. This was recognised by the great investor Warren Buffett in his Preface to Benjamin Graham’s The Intelligent Investor, when he wrote: “What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from eroding that framework.”

The other reason psychology is important is that for centuries economists have based their work on the assumption that we are rational in all our decision-making. This made theory easier to construct, but the resulting insights lack reality and sometimes lead up blind alleys. More recently, economics and psychology have begun to be blended together in studies of the real world and a new school called “Behavioural Finance” has emerged.

Cohen’s book is from the new mould. It takes a refreshingly new look at the real world of markets, their participants and the way we make decisions. His intellectual integrity shines through and he is critical of earlier researchers who have come up with conclusions by reasoning only, rather than by observation and testing.

One of the strongest contributions of the book is that Cohen identifies how almost everyone plays lip service to psychology by saying that markets are driven by fear, greed and the herd instinct. However, this shallow statement is as far as their knowledge goes. Cohen makes the point that
markets are so much more complex that such simple “motherhood” statements suggest. His book is an attempt to tackle some of these issues.

Equally important to my mind is the discussion about the way cognitive dissonance works its spell on all of us. This basic concept from psychology explains much of the behaviour of market participants that seems so inexplicable to those who are not involved in the process of booms and busts. Once you have read this book, you will never look at the investing process the same way again.

One problem with some books is that we have difficulty identifying our own attitudes to the issues. A key issue in investing and trading is our attitude to risk, since it is by assuming risk that we seek to profit in the stock market. Some institutions publish questionnaires to assist us in assessing our attitudes in this area. However, they tend to be suspect on the grounds that they are disguised selling tools to guide us to their products and services.

Cohen is not selling his services as a fund manager or adviser (yet?). He is also a qualified psychologist. His inclusion in the book of a lengthy questionnaire on our attitude to risk is therefore a significant contribution to our search for self-understanding.

The discussion of our attitudes to shares in terms of them being “wet” or “dry” was new to me and added to my understanding of why we buy some shares rather than others. Also why some shares tend to overvaluation and others fall from grace at the slightest signs of trouble.

This book will open your eyes to many aspects of investing that are not covered in the standard textbooks. It is a serious contribution to the literature about markets.

*Published in Shares magazine December 2001 titled It’s all in the Mind*