Opinion: We’re not smart enough to spot a coming stock-market crash

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Video by Bloomberg

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The psychology of money and investing is infuriating. Economists assume we’re rational beings, that we constantly evaluate cost and value to maximize utility. But too often we realize too late that the sort of thinking that once helped us survive a prehistoric moment of danger — when we were prey as much as hunter — doesn’t do much good when the danger is modern and longer term.

One problem investors face is the concept of the “anchor” price, first described by Daniel Kahneman and Amos Tversky. Regardless of the value of a share of stock, we tend to believe that value must be close to the only bit of information many of us have — the current price. This anchoring effect makes it easier to justify paying a wildly inflated price for a company that is operating at a loss or for a market that is hugely overvalued by any objective measure.

Another common fallacy investors face is herding, or the tendency to use the actions of others as a measure of sensible behavior. Fads, fashion, and stock-market bubbles are three examples of this mindset. When investors lose the sort of hard-nosed skepticism and difference of opinion that marks a healthy market, it becomes fashionable, and nearly unavoidable, for too many investors to buy too many stocks that have too little going for them.

If it were just psychological quirks that lead to runaway stock market rallies, the bubble might deflate itself slowly as the anchor price is gradually lowered and as financial fads and fashions change.

But the stock market isn’t a purely psychology exercise; too often the real world intrudes. Each modern stock-market crash has been precipitated by a catalyst that has little to do with finance and that catches us off guard. These catalysts push a system barely able to maintain equilibrium into chaos.

Many of us remember the stock market crash of Oct. 19, 1987 — and little else from that month. But on Oct. 16, the Iranian military attacked a U.S.-flagged oil tanker in the Persian Gulf, and two days later the U.S. Navy responded by bombarding Iranian oil platforms. Anyone listening to the news on the morning of Monday, Oct. 19, would have thought we were finally at war with Iran. A market that was barely able to maintain equilibrium — the Dow Jones Industrial Average had suffered its largest-ever one-day drop up to that point the previous Friday — was tipped into a crash because of something no investor could foresee. Other crashes have similar catalysts.

Each crash is abetted by a novel financial contraption that many ordinary investors have never heard of or don't fully understand, making it impossible to account for the leverage these gadgets inject into the system when it is at an inflection point.

The benign-sounding investment trusts of the 1920s were a wonderful way for ordinary Americans to invest modest amounts in diversified funds — until the metastatic introduction of leverage by fund sponsors. Soon it wasn't unusual for an investment trust to be levered 8 to 1, something that only makes sense in the context of herding.

In the 1980s, portfolio insurance, a blindingly complex offshoot of the new math of valuing derivatives, promised to eliminate risk for some shareholders while actually increasing risk for everyone when the utopian assumptions inherent in the math failed to hold.

A few decades later, the universe of mortgage-backed securities, which had solved several problems for institutional investors and homeowners, fostered many new and more insidious problems once bankers learned they could reassemble mortgages in novel ways — not because the new way was better but rather because it could be sold.

Where are the regulators while investors are herding and bankers are devising the latest in a string of unfortunate financial "innovations"? Like the rest of us, they fail to recognize the danger, and too often they add to it by pursuing their own agendas.

Alan Greenspan resolutely refused to regulate mortgages and mortgage bankers in the last decade despite laws that required the Federal Reserve to do so and warnings that they should.

Benjamin Strong was president of the New York Federal Reserve in the 1920s. His ill-conceived attempt to help his friends in England return to the gold standard led him to push interest rates in the United States so low that speculators gobbled up the cheap money and fueled a stock-market boom that ended with the crash of 1929.

It is easy to believe the differences between our current financial world and that of just a few years ago — some call them advances — render another crash impossible. But financial minds are actively searching for the next contraption. Risk-parity investing, which uses leverage, might be the next vehicle to push a market on edge into chaos. Similarly, if a geopolitical problem is the catalyst for the next crash, it's difficult to know where to look first. And the raw material for a crash is a buoyant stock market. The S&P 500 (SPX) Dow Jones Industrial Average (DJIA) and Nasdaq Composite (COMP) have all recently traded around all-time highs.

The world of finance is full of charlatans constantly warning of an impending crash in an effort to sell you gold or get you to subscribe to their newsletter. The result is another human quirk: We tune out the drumbeat of warnings and fail to recognize when we've actually joined the herd. Investing has always required discipline, and in the age of 24-hour financial media and Twitter, recognizing the signal amid the noise will require more discipline than ever.

The American investor has done more good in this world than anyone with the exception of the American soldier. But our stock market will crash again — because we're human.