



Tomorrow's Capitalism

Seminar summary

The Institute for Public Policy Research (ippr), in conjunction with Friends Provident Foundation, last year launched Tomorrow's Capitalism, a major new programme of work that aims to explore the future of our financial and economic system.

As part of the Tomorrow's Capitalism programme, a series of seminars is taking place to consider how the capitalist system might evolve as a result of the current crisis.

'Addressing the psychology of financial markets'

14 May 2009, ippr offices

With Professor David Tuckett, University College London; chaired by Tony Dolphin (ippr)

Presentation

Professor Tuckett argued that the key to understanding financial markets, and the development of asset price bubbles in particular, is the co-evolution of human nature and financial institutions. Psychoanalysis can help because of its emphasis on how emotions influence thoughts – asset bubbles are essentially emotional sequences.

When a bubble starts to develop, excitement at the prospect of large gains becomes separated from anxiety about the risk of a loss; greed dominates fear of consequences and a "divided" mental state is created. In aggregate in this state of mind, risk-taking becomes excessive, but it is not perceived as such. Stories develop which appear to support the excitement.

The stories centre on 'phantastic objects' – new ideas or paradigms that appear to offer the potential for massive but rather unspecified rewards. These are always new, rather complicated and not totally understood (like a CDO) and convey the idea of change for the better. People who question their value are widely mocked, while their supporters ignore the small print setting out the dangers. This is not stupidity, or even a lack of rationality – it is the emotions taking over.

Within fund management operations, groupthink develops, creating pressure on fund managers to participate in the developing bubble. Individuals' sense of reality becomes governed by a divided state of mind, as opposed to an integrated state of mind. Mental tricks are developed to deal with news that appears to contradict the prevailing positive sentiment towards the bubble.

Eventually, people see the light. Though it is very difficult to predict how and why this will happen, it is usually around the time counter-arguments are being dismissed with great certainty. When the bubble bursts, the stories that have been supporting it no longer appear valid and there is an emotional switch to revulsion. This is followed by a search for someone to blame which can prevent the opportunity to learn. Learning requires a return to an "integrated" state of mind in which uncomfortable thoughts (like feeling guilty and so responsible) can be accepted and a more balanced sense of reality obtained.

The structure of the fund management industry does not help. Funds are advertised as delivering exceptional performance; both reflecting and provoking the belief that fantastic performance is achievable and putting pressure on managers to perform exceptionally in future. Managers have to seek out exciting opportunities just as investors tend to seek new asset classes or fund methodologies – for everyone ordinary performance is insufficient. This adds to the tendency to think about risk and reward in a “divided” state and so to overemphasise excitement and underestimate risk.

Discussion

The discussion following the presentations, based on questions from the audience, was wide-ranging. Among the main points that were made were:

- Fund managers believe their own stories – and so do their clients.
- Financial assets are different from consumer goods and services. After you have bought an asset you have, in effect, to renew your commitment to it every day (or sell it), whereas with most consumer goods you have to stick with your choice. This creates the need for a story.
- Bubbles need something to get them started – e.g. big technological change, financial innovation – and it is not always clear why they start to develop, but once they do people get involved, a conventional wisdom develops and people start to do what other people are doing.
- The media do not cause the process of bubble development but they do amplify developments by contributing to the conventional wisdom.
- The lesson for policy is that the current approach to regulation is unlikely to prevent future bubbles. Investors, fund managers, regulators all need to understand the processes that create bubbles and to change their behaviour in awareness of the common interest.
- “Divided” states of mind and Groupthink have its advantages as well as problems – e.g. it is encouraged in the military where breaking ranks is a serious problem so that individual thought can be a problem.
- George Soros is an intuitive psychologist who understands these arguments, in particular how hard it can be to grasp and then act on information that counters an investment thesis.

Conclusion

A psychoanalytical approach helps us to understand financial markets better and particularly behaviour when asset price bubbles are inflating and bursting. It also points the way to recognising and preventing bubbles at a much earlier stage in the future. However, this will require a collective re-examination – by investors and fund managers - of the way savings are managed. It also requires an understanding of the value to everyone of regulation and the need, sometimes, to say “no”.