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Stock Market Crash: Understanding the Panic

Market psychology experts weigh in on what's feeding the selling frenzy on Wall Street and when to look for investors' moods to change

Photo Illustration: David Sleight/BW; Photo: Spencer Platt/Getty Images by Ben Steverman

Searching for a way to describe the current stock market meltdown? Call it the "Panic of 2008."

In the past century, the world has seen countless financial crises, economic downturns, and market crashes. But the last major event to be called a 'panic' was the Panic of 1907.

If ever it were appropriate to revive the term "panic," this is the time. The day-after-day declines in the stock market are unprecedented.

The S&P 500, the broad U.S. stock index, has lost 22% of its value in six trading sessions, from Oct. 2 to Oct. 9. Brian Gendreau of ING Investment Management points out that the Dow Jones industrial average, founded in the late 19th century, until this month had never seen six consecutive daily declines of 1% or more.

Forget Normal

Normally even falling stock markets take a break from time to time, as the vultures swoop in to pick up stocks at bargain prices.

But now, the market's psychology is anything but normal.

Every time the stock market rallies—as it did on the morning of Oct. 9—"there are tons of sellers everywhere," says Dave Rovelli, managing director of equity trading at Canaccord Adams. "People just want out."

Panic in financial markets—just as in everyday life—is explained by the fight-or-flight instinct. "That makes people overreact," says Avanidhar Subrahmanyam, a professor and expert on market psychology at the UCLA Anderson School of Management.

Not only are stock traders running scared, so are financial institutions. "You've got panics not only among individual investors but panic in the industry itself," says John Merrill, chief

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investment officer at Tanglewood Wealth Management.

Dysfunction in the credit markets means financial firms lack the confidence to transact business with each other.

Irrational Despair?

A panic is a "situation in which people do things that contradict rationality," says Paolo Pasquariello, a professor at the University of Michigan's Ross School of Business.

But by that definition, is this really a panic? "It's difficult to say people are selling because they are panicking," Pasquariello says. Selling now isn't necessarily irrational, he says. There are plenty of good reasons to move from riskier to safer investments at a time when the financial system has stopped working and a serious economic slowdown looks imminent to many economists.

By contrast, Subrahmanyam is more convinced the markets are behaving irrationally. It's not as if we've had a nuclear war and "real" assets were destroyed, he says. Rather, problems are in the financial sector, not the "real" activity in the rest of the economy. "The real, nonfinancial base of the economy is still fairly strong," he says—far stronger than during, for example, the Great Depression.

Bargain Basement

"Financial panics don't last forever," says ING's Gendreau. Eventually investors will realize that many assets are trading at deep discounts. "Either we're going to go into a Great Depression, or some of these assets are trading at very attractive prices," he says.

Many market participants believe the wave of stock selling is being pushed by hedge funds and other institutions that must sell assets to raise cash. Often these assets—from stocks in solid companies to municipal bonds—are being sold without regard to their inherent value. But, before jumping back in the market, "You wait for the forced selling to run its course," Merrill says.

So when might this downward spiral end?

Because of our flight-or-flight instincts, Subrahmanyam says, "things are very quick to crash." But "the recovery takes much longer."

You First

"The market ultimately reaches a bottom," says Georgetown University finance professor Reena Aggarwal. However, "no one wants to be the first to move. The markets behave in a herd mentality."

Pasquariello worries governments may simply blame market troubles on panic and irrationality—"on people being crazy." That gives them the excuse to step in and try to restore market confidence in artificial ways—such as the its recent ban on the short-selling of financial stocks, which he opposed. The real reasons for the financial crisis will "take a long time to fix," Pasquariello warns.

By its nature, a crisis is a time of uncertainty. It could be months before we know whether markets are crashing because of irrational fear or because of real economic problems. And that's scary.

Steverman is a reporter for BusinessWeek's Investing channel.