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PERSONAL FINANCE

The psychology of financial panic

The stock market meltdown is triggering severe reactions by investors. Resist being swayed by the masses – unless joining them makes financial sense.

By Kathy M. Kristof
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Having trouble investing wisely in today's tumultuous market?

The problem may be your brain.

Brad Klontz, a Hawaii-based psychologist who specializes in financial disorders, says that thanks to lessons we learned as cave dwellers, human beings are psychologically pre-programmed to deal irrationally with financial shocks.

We flee in the same direction as the rest of the tribe, because at some deep level we believe that if we don't, we're going to get trampled or eaten, he said. And we're so emotional: 80% of the gray matter in our brains is dedicated to dealing with feelings. Just 20% is analytical.

Under normal circumstances, the analytical mind directs the emotional mind, a balancing act he likened to a performer (your analytical brain) riding an elephant (your emotional brain).

"That works really well until the elephant gets scared," Klontz said. "At that point, the elephant is going to go wherever it wants."

So what should you do?

Face your fear

The first problem people have when dealing with financial fears is their predisposition to react, said Rick Kahler, a fee-only financial planner and a coauthor of several books on the psychology of money. When dealing with a fearful situation, humans typically respond with one of the three Fs – fight, flight or freeze.

Often, they react before they even think about why.

Instead, Kahler said, you need to recognize that you find the situation frightening and wait at least 20 minutes before doing anything, he said.

Why? Your body floods your brain with chemicals when you're frightened, which makes it difficult for the analytical side of your mind to function. You need to recognize that this chemical flood is making you overly emotional and let it recede before you react.

Is your fear rational?

It's rational to be fearful about a falling stock market if you're going to need the money soon, or if you've invested in companies that seem to be headed for bankruptcy.

But fear about a stock drop when only long-term money is in the market may not be rational. That's because you may have enough time to let the market climb back. If you have the resources to save more, or have the ability to create another contingency plan, you will be more likely to survive the storm.

One reason people worry about short-term drops is that it can be difficult to predict the cost of amorphous goals like retirement. Still, you can make a stab at it by sitting down with a pencil and a pad and working through where your sources of retirement income (or college income, if that's what the money is saved for) will come from.

For instance, if you're estimating what you'll need for retirement, you need to consider whether you'll receive Social Security. If so, how much? (Go to www.ssa.gov for an estimate if you're not sure.)

Are you entitled to a pension, which pays a set amount each month for life? If so, estimate the amount.

Now figure out roughly what you expect to spend in retirement. If it's more than the amount you're likely to get from Social Security and pensions, you need savings to finance the gap.

That savings can come from the amount you already have invested, from amounts you save between now and then, and from equity you have in other assets, such as your home.

Assuming a conservative rate of return – maybe 5% – from now until then, are you likely to have enough? If not, your worries are rational, and you will need to try to find another way to make do.

Investment reality check

When it comes to your individual investments, a similar reality check is in order.

Analyze the companies in which you hold stock to see whether they continue to be well-managed and whether their business models are still sound.

In today's environment of tight credit, you need to be particularly mindful about whether the companies you are investing in have sufficient cash flow to finance their operations without a lot of borrowing. If they don't, they're far more susceptible to trouble than companies that are capable of generating more cash.

If you determine that the company stocks you own are still valuable, don't sell. You may even want to buy more. But if the analysis makes you question why you bought this loser in the first place, consider dumping the stock.

Avoid compulsiveness

There are a variety of compulsive behaviors that run rampant when people are under stress, Klontz said. Compulsive spending, pathological gambling and compulsive drinking and fighting can all be brought on by a financial challenge.

Any one of those behaviors can worsen any real economic problem you might experience.

"You have to find a healthy way to manage your stress," Klontz said.

Exercise and talk with friends, or even with a psychologist or medical doctor, if your stress feels out of control, he suggested.

Know your money script

Many people have subconscious scripts that they follow with money – things that they learned from their parents or during childhood. These scripts may cause them to sell everything once they've suffered a set loss – or get too aggressive when investing because they expect a vast win.

Klontz said his grandfather, who suffered through the Great Depression, kept all of his money in a safe in the attic; his mother was also skittish of financial risks, so she invested overly conservatively, he said. He saw that growing up and decided that being conservative was a huge mistake – so he decided to do just the opposite. He invested virtually all of his assets in tech stocks right before the bubble burst in 2000, he said. That personal experience is what got him interested in financial psychology.

Once you make those unconscious money scripts conscious, you can address whether they're reasonable, he added. If you have trouble doing it alone, hire a financial planner, he suggested.

"What's going on in the stock market is probably not a threat to our lives," Klontz said. "But we react like we're in the jungle, being chased by a saber-toothed tiger. Making financial decisions in that state is very destructive."

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