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Don’t Let Other Investors Make Up Your Mind

PHOTO: CHRISTOPHE VORLET

By **JASON ZWEIG**
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Confidence is contagious. But acting on it can be dangerous.

Although it has slipped a bit lately, the S&P 500 stock index is up almost 6% since Election Day, and surveys show that investors are feeling sharply more optimistic.

It’s fine to bask in that good feeling if you wish, but you must also be on your guard. New research shows that the confidence of others can influence your decisions even more than your own experience can. At a time when stocks and bonds alike are expensive, investors need to be even more vigilant than usual against the risk of getting stampeded by other people’s emotions.

An article published this past week in the Journal of Neuroscience finds that a particular region in the human brain monitors how positive other people seem to be about their choices.

“We’re biologically equipped with the potential to allow more-confident people to have greater sway over our own beliefs,” says Daniel Campbell-Meiklejohn, a psychologist who runs the Social Decision Laboratory at the University of Sussex in the United Kingdom and who led this study.

Participants in the experiment guessed whether the next marble drawn from an urn would be red or green. They could rely on the colors of the last few marbles they had picked themselves. They were told they could also take account of what up to four other people were forecasting — and how confident the strangers were in those predictions after sampling a few marbles.

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Naturally, the participants were more likely to predict that the next marble would be red if most of their recent draws from an urn had also been that color.

They were even more prone to pick red, however, when they learned that other people had confidently chosen it. Confidence, in the experiment, was represented simply by how fast the other people picked the color and whether they smiled as they did so.

Brain scans showed that the prefrontal cortex responded differently, depending on whether the participants relied on their own experience or on how decisive other people were.

“The human brain has evolved with neural mechanisms to handle the uncertainty that accompanies social sources of information,” says Prof. Campbell-Meiklejohn. That sensitivity to cues about how sure other people are “can operate independently of learning from first-hand experience.”

And confident investors suddenly seem to be everywhere.

Robert Shiller, the economist at Yale University who won a Nobel Prize in 2013 for his research on inefficient markets, has long measured the confidence of professional and individual investors. (“Confidence,” here, means the percentage of investors who expect stocks to have a positive return.) In December, the proportion of individuals in the survey expecting the Dow Jones Industrial Average to go up over the coming year rose from 68.5% to 75.8% — the sharpest increase since Prof. Shiller began reporting updates monthly in 2001.

A survey of more than 2,000 wealthy investors, released by UBS Wealth Management Americas this past week, found that 58% were optimistic about the economy over the coming year, up from 39% in mid-October. Even investors who had supported Hillary Clinton became significantly more sanguine.

And 42% of investors said they were likely to raise their exposure to stocks, up from only 9% before the election.

Regardless of how they might feel about Mr. Trump, says Paula Polito, client strategy officer at UBS Wealth Management Americas, "the rally has made everybody who's invested in the market more optimistic."

But the history of such measures suggests that investors' confidence is a poor predictor of how well markets will perform. In a paper published in 2000, Prof. Shiller showed that confidence varies over time, often going up after the market rises and falling after it goes down.

The confidence of individual investors rose by 4% in July 2008, for instance — right before the U.S. stock market got sucked into the black hole of the global financial crisis.

Conversely, from August 2012 through January 2013, the confidence of individual investors declined in five of six months; institutional investors became less optimistic in four out of those same months. Nevertheless, the S&P 500 gained 32.4% in 2013.

Overall, the confidence of professional and individual investors has a perverse quality. Sometimes high confidence is a bellwether of low returns and vice versa. But most of the time, what the market does next has nothing to do with how optimistic investors are about it; the results are disconcertingly random.

So you could visualize the stock market as a poltergeist or hobgoblin who takes a twisted delight in playing pranks on the expectations of the investing public.

Meanwhile, the more cocky those around you become, the more important it becomes to wall yourself off from their influence.

This bull market for stocks is 94 months old, making it the second-longest in modern history, according to S&P Dow Jones Indices. Now more than ever, you should take extra risk only because your own rigorous analysis leads you to conclude that it's a good idea, not because other folks think it is.

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