THE INTELLIGENT INVESTOR

How to Stay Sane When Markets Get Wild

Market strategists and online pundits always have explanations for stock-market volatility. That doesn't mean you have to believe them.

By Jason Zweig Follow
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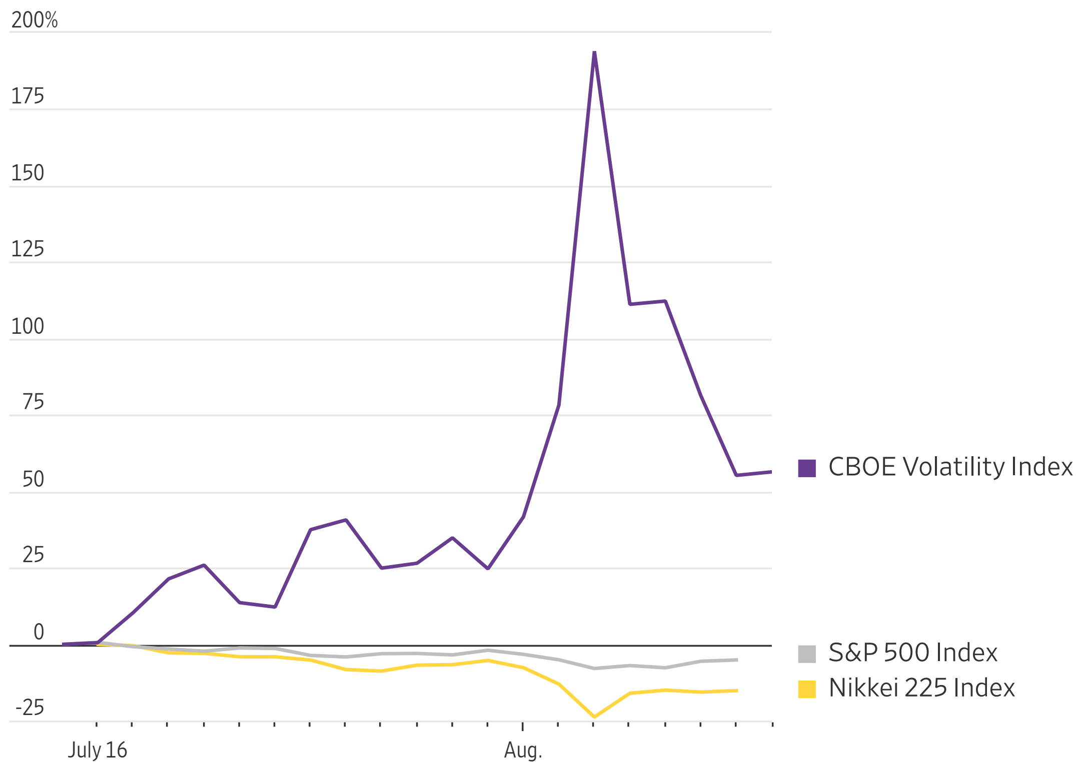
Stop trying to make it make sense.

Just about every volatility storm in the markets quickly morphs into a baloney blizzard, as Wall Street's market strategists and a swarm of online pundits pretend to explain what just happened and concoct predictions of what will happen next.

It's time to sharpen your critical-thinking skills. To stay the course as a long-term investor amid this short-term turbulence, you will need them.

On Monday, Aug. 5, the Japanese stock market had its worst day since 1987, crumbling 12.4%, and U.S. stocks slumped 3%. Wall Street's fear gauge, the VIX index of volatility, shot up more than 50% to its highest level since the dark pandemic days of 2020. The next day, Japan bounced up 10%, while the S&P 500 gained 1% and the VIX fell 28%. By week's end stocks stood not far below where they did before the wild ride.



Source: FactSet

Were the future cash flows of Japanese corporations one-eighth less valuable on Monday than the day before—and then one-tenth more valuable on Tuesday?

Of course not. But the more implausible an event feels, the more the human mind seems to crave a plausible explanation for it.

What's the harm in that? A believable story might lead you to think you know exactly what's coming next and to trade on that belief, when it's probably nothing but a delusion. Or a compelling narrative might prompt you to believe the teller saw the whole thing coming, when that wasn't the case.

Nearly a century after the crash of 1929 and almost four decades after the crash of 1987, no one knows for sure what caused either one. But this week, Wall Street was already abuzz with confident theories of what had happened on Monday.

Big hedge funds had borrowed in cheap Japanese yen to buy U.S. stocks and other assets, then panicked when the yen suddenly rose against other currencies, making the borrowings more costly. Or investors had suddenly lost confidence that the Federal Reserve could prevent the economy from sagging into a recession. Or expectations for big technology stocks had gotten out of hand.

More likely, the extraordinary smoothness of markets over the past year-and-a-half had goaded hedge funds and other big traders into taking ever-escalating amounts of risk. From Feb. 22, 2023 to this July 23, the S&P 500 never dropped by more than 2% in a day, the longest such streak in more than 17 years.

But you can only stretch a rubber band so far until it snaps, and when it snaps it stings.

The simplest explanation of all: Markets went haywire early this week because markets consist of people, and crazy behavior is contagious. To paraphrase Mark Twain, truth is stranger than fiction because fiction has to make sense. Markets don't.

No less an authority than Paul Samuelson, the Nobel laureate in economics, who died in 2009, argued that markets are "micro-efficient" but "macro-inefficient."

By that he meant that investors are good at quickly integrating new information about individual securities—but bad at sizing up geopolitical and macroeconomic developments that can affect entire categories of assets like stock, bonds or commodities.

In a private letter later published by Robert Shiller, the Yale economist who eventually won a Nobel Prize himself, Samuelson defined macro-inefficiency as "long waves" of prices for broad baskets of securities "below and above... fundamental values."

Shiller tells me he believes markets are micro-efficient but macro-inefficient because an individual security is discrete and affected by a fairly limited number of factors. Broader bundles of assets like entire national stock markets can be swayed by countless forces, making their value "more subjective," he says.

And he thinks macro-inefficiency can unfold not just in the long waves that Samuelson assumed, but in short bursts as well.

"There's a narrative that big market moves are a leading indicator, and it's a very fast-acting leading indicator," Shiller says. "The human sympathetic nervous system evolved for us to jump to action in an emergency. Time is sped up. People drop what they're doing and think, 'I've got to handle this.'"

That urge is exactly what brokerage firms and trading apps play—and prey—on. And it's what long-term investors must be on guard against.

Financial marketers grab and hold your attention online by playing on your emotions, especially fear and anger.

Their simplest trick is what I call hiding the denominator. DOW PLUNGES MORE THAN 1,000 POINTS sounds scary, because it obscures the starting point of the decline.

To control your fear, simply ask, “What’s the denominator?”

The Dow Jones Industrial Average’s previous close was 39737.26; that’s the denominator. The drop on Aug. 5 was 1033.99 points; that’s the numerator. Divide the numerator by the denominator and the “plunge” becomes a 2.6% drop.

That isn’t a small decline, but it feels a lot less alarming than DOW PLUNGES MORE THAN 1,000 POINTS. Your intuition will naturally fixate on “MORE THAN 1,000,” because it’s so obviously a big number.

By redirecting your attention to the denominator, you push yourself to do what Darrell Huff, in his classic 1954 book “How to Lie with Statistics,” called “talking back to a statistic.”

Here’s another example of how to do that—and why it’s an important tool to keep you on course as a patient investor.

On Tuesday, thousands of social-media accounts shared a variation of this shrieking message:

“BREAKING: JP Morgan says institutions bought the dip, while retail investors panic-sold aggressively. Retail SOLD $1 billion.

Institutions BOUGHT $14 billion.”

Let’s discover the denominator together.

According to readily available data from the Federal Reserve’s Survey of Consumer Finances, 58% of U.S. households own stock either directly, or through mutual funds, exchange-traded funds or other pools of investments.

The Census Bureau counts 131.4 million households. Combine those two numbers, and 76.2 million U.S. households own stock.

If, as the JPMorgan report estimated, they sold $1 billion of stocks (and stock funds) all told, that’s an average of $13.12 per household.

According to the Federal Reserve, the median household owns about $52,000 in directly or indirectly held stock. That means that if JPMorgan’s numbers are correct, on Aug. 5, the typical U.S. household sold 0.025% of its total stockholdings.

That’s one-fortieth of one percent.

“Panic selling”? Are you kidding me?

Nowhere did the original JPMorgan report use the word “panic.” It stated simply that “retail participants were aggressive net sellers today,” with net sales of $1 billion, well below the usually positive average daily net flow over the past year.

Hiding the denominator and hyping the numerator is how online commentators distort matter-of-fact observations into messages meant to instill fear.

Other talking heads on social media tried to foment panic by emphasizing that the S&P 500 lost more than a “TRILLION” dollars on Aug. 5, without pointing out that the total market value of the index was just under $45 trillion before the drop.

You don’t have to try to make sense of markets that make no sense. And you certainly shouldn’t listen to anyone trying to make you panic.

Learning how to talk back to statistics is your first line of defense—and the best way to maintain an even keel when markets go bonkers.

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