Can You Handle the Market's Stress Test?

By Jason Zweig

Investing graybeards like to say that "bull markets climb a wall of worry." This one has been sleepwalking up a wall of boredom.

As of this Friday, the S&P 500 has gone 980 days without a 10% decline, according to Birinyi Associates, the fifth-longest such stretch on record. This past week's nervousness, set off by the insurgency in Iraq and the surprise defeat of U.S. Rep. Eric Cantor, is thus the perfect pretext for investors to think about what they will do when the market takes a serious beating.

For, sooner or later, it surely will—and those investors who have honestly prepared for it will stand the best chance of surviving unscathed. In a downturn, you won't be the same investor that you are now—unless you rely on rules and procedures, rather than willpower alone, to regulate your behavior.

New research shows that the kind of stress brought on by a collapsing stock market fundamentally changes how people make financial decisions.

In a series of recently published experiments, Mauricio Delgado, a neuroscientist in the psychology department at Rutgers University in Newark, N.J., has found that even a moderate amount of sudden stress can make people more sensitive to losses and indifferent to small gains.

In these experiments, people are put under stress by immersing their dominant hand in ice water (at about 39 degrees Fahrenheit) or wearing an arm wrap cooled to the same temperature. Shortly thereafter, most people show an impaired short-term memory and an elevated level of the stress hormone cortisol. Stress in the world outside the laboratory, often brought on by social interactions, is almost certainly more intense than this simple simulation in the lab, says Prof. Delgado.

People are then asked to choose between simple gambles with varying odds and different amounts of money at stake. Under stress, participants gravitated toward bets giving them a higher probability of making a smaller amount of money. When gambles paid off, brain scans show, the natural response in the reward areas of the brain was blunted by stress.

"Exposure to stress makes people more loss-averse and diminishes their overall sensitivity to reward," says Prof. Delgado. "And if a reward is of low magnitude, [people under stress] often don't care about it very much."

Thus, at the very moment when falling prices make assets more attractive to own, most investors are likely to focus on how much they are losing in the short term—rather than on how much they stand to gain if they hang on for the long term.

They are also likely to fall back on emotional—or what Prof. Delgado calls "habit-based"—decisions. "Stress tends to exacerbate your typical biases," he says. "If you usually make conservative choices, it will make you more conservative." And if you typically make risky choices to avoid locking in losses, he says, stress "will make you more risk-seeking." Other researchers have found similar patterns of behavior.

That helps explain why investors who swore they would never sell often end up fleeing to cash when stocks drop, while others add more to their positions than they ever anticipated.

In calm times, like the markets of the past few months, it's hard to imagine how you will feel when all the arrows turn to red from green. What's more, even in the heat of the moment, when your body and brain show the signs of acute stress, you might not be consciously aware of the pressure you are under.

So it's vital to make sure you have procedures in place now to control your future stress.

Start by asking yourself where the potential is greatest for nasty surprises. One obvious vulnerability: Companies that have rung up a long string of consecutive earnings increases are likely to fall much more steeply than average once their profits falter. If imagining the stock price falling by, say, one-third doesn't make you want to buy more, then you probably should consider selling now.

Force yourself to consider the total value of your portfolio, including all other assets, rather than just focusing on the price of your latest loser. That is often called "thinking like a trader," although you don't have to be a trader to do it.

By netting all your gains and losses against each other, research by several economists and psychologists has shown, you can reduce the intensity of your emotional response to falling prices. Be sure you have set up a spreadsheet or portfolio-monitoring software that displays the value of your overall portfolio more prominently than any individual holding.

If you haven't recently "rebalanced," selling a bit of whatever has gone up the most and adding the proceeds to whatever has gone down the most, now is an ideal time.

Taking moderate action now, while markets are still calm, should help you avoid doing something reckless when investing turns suddenly stressful.

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