

The Fundamentalist

A sense of risk can infect you without your even being aware of it. Psychologists have found that merely *reading* about deaths caused by homicide or leukemia can lead people to overestimate the risk of hazards that have nothing at all to do with leukemia or homicide. Thus in the wake of Sept. 11, an intangible feeling of risk fills the air.

The uses of fear

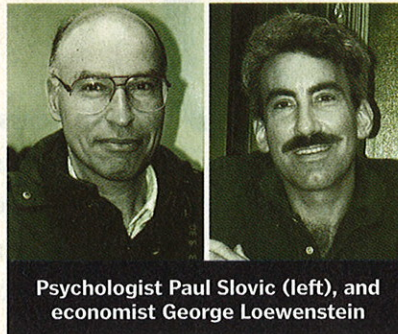
To act rationally, you need to separate how risky a situation feels from how risky it really is. Scientists now believe that our brains make judgments in two basic ways: with an emotional, rapid-response system and an analytical, slower-moving side. To make consistently rational choices, we need both.

Led by Antonio Damasio at the University of Iowa, neurologists have shown that we rely on our emotions even when engaged in advanced reasoning. In one famous case, a railroad worker named Phineas Gage suffered a freak accident in 1848 that damaged the part of the brain that processes emotion. Scientists observed that Gage's intelligence and logical reasoning were unimpaired—but the injury crippled his ability to make long-term plans or major decisions. Without normal input from his emotions, rationality alone couldn't guide him to sound judgments.

In other words, we think both with our heads and our hearts. "Visceral emotions can cause us to do things that aren't wise," says Slovic. "But a faint whisper of emotion can help us fine-tune our analysis." The trick is to recognize that you're driven partly by your feelings and to integrate them into your analytical judgments. When danger seems acute, people rely more on emotion and less on analysis. In the days after the market reopened for trading on Sept. 17, for example, many investors panicked and dumped their stocks. As a result, they missed out on one of the best months in the Nasdaq's history, as the index surged 22% from Sept. 21 through Oct. 25. In times like these, it's crucial to counterweight your emotions with objective data.

I once asked Brian Posner, a gifted fund manager at Fidelity and Warburg

Pincus, how he knew that a stock was likely to work out well when he bought it. "If it makes me feel like I want to throw up," he replied, "I can be pretty sure it's a great investment." Posner wasn't being facetious. The best investments are often those that make you queasy; after all, if a stock has suffered a sickening drop, it may finally be selling at a worthwhile discount. Like Posner, you should listen to both your gut and your head. Think of your own fear as a barometer of how nervous other



Psychologist Paul Slovic (left), and economist George Loewenstein

"We underestimate our powers of recuperation," says Loewenstein.

investors may be feeling. And, if you're scared, that's all the more reason to study the evidence carefully.

The shock of recovery

We often think, when we're upset, that we'll stay that way. "People underestimate their ability to adapt to both good things and bad," says George Loewenstein, an economist at Carnegie Mellon. "Think of what happens when you drive past a terrible accident by the side of the road. You hit the brakes and say, 'That guy must have really been speeding,' and you promise yourself you'll never go too fast again. But an hour later, there you are, back to driving 79 mph."

In the heat of the moment, explains Loewenstein, we expect our current feelings to last for ages. But as time passes, we feel better—even after traumas like the death of loved ones. Daniel Gilbert, a behavioral scientist at Harvard, calls

this mental quirk the "psychological immune system." Because we imagine that our reactions to bad events will never fade, we tend to feel especially good when we recover from trauma with unexpected speed. When fear and panic run hot, it seems inconceivable that anyone will ever calmly buy stocks again. But once those emotions recede, we're surprised at how much better we feel—one reason why bear markets often end suddenly, in stunning surges of bullishness.

Thus, as an investor, you should realize that the pundits who are proclaiming that "nothing will ever be the same again" are almost certainly wrong. We're likely to recover sooner than most of us imagine. Realizing this can help you stay put in the market, so you won't be left behind as it rebounds.

Of course, long-term investing returns have almost nothing to do with how you, or anyone else, feels right now. In the end, stocks are driven by earnings, not emotions; bond returns are based on interest rates, not intuition. But that's hard to remember when everyone is so full of anxiety.

The best way to prevent your emotions from bulldozing your judgment is by forcing your logical side to weigh in. Psychologist Paul Slovic suggests asking yourself, "What really is worrying me? What evidence do I have about how likely it is? Has the world changed so drastically that the past has no relevance to today?" (A quick check at, say, www.djindexes.com will show you that there is no historical evidence that war or physical disaster is bad for the U.S. stock market.)

Finally, remember George Loewenstein's observation: "People underestimate their own powers of recuperation from emotional trauma." None of us will ever forget the horror of Sept. 11, but someday we'll look back and be amazed at how much calmer we've become. In the end, we'll find that investing victory will belong to those who realized, early on, that psychological victory was possible. ■

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