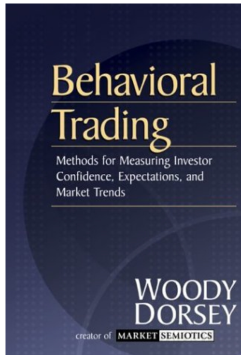
getAbstract
compressed knowledge



Behavioral Trading

Methods for Measuring Investor Confidence, Expectations, and Market Trends

by Woody Dorsey
Thomson Texere © 2004
247 pages

Focus

- Leadership & Mgt.
- Strategy
- Sales & Marketing
- Corporate Finance
- Human Resources
- Technology & Production
- Small Business
- Economics & Politics
- Industries & Regions
- Career Development
- **Personal Finance**
- Concepts & Trends

Take-Aways

- Behavioral economics has always been part of finance, though it has not been widely acknowledged.
- The idea that people behave rationally when they invest is irrational.
- Rational economics cannot explain sudden booms or bursting bubbles.
- Psychological and behavioral factors matter greatly in the market, which has its own mind (emotions), mood (concepts) and body (prices).
- Mind, mood and body work together and feed each other.
- People follow contagious information patterns called memes that invade their minds and change their behaviors.
- Memes are one reason that investors repeat themselves disastrously and never seem to learn from their mistakes.
- Published information is disinformation.
- Read the paper to see what people think; ride trends but be ready to bet against them.
- People who invest based on behavior finance may find charted trends useful.

Rating (10 is best)

Overall	Applicability	Innovation	Style
9	**9**	**10**	**8**

To purchase individual Abstracts, personal subscriptions or corporate solutions, visit our Web site at www.getAbstract.com or call us at our U.S. office (954-359-4070) or Switzerland office (+41-41-367-5151). getAbstract is an Internet-based knowledge rating service and publisher of book Abstracts. getAbstract maintains complete editorial responsibility for all parts of this Abstract. The respective copyrights of authors and publishers are acknowledged. All rights reserved. No part of this abstract may be reproduced or transmitted in any form or by any means, electronic, photocopying, or otherwise, without prior written permission of getAbstract Ltd (Switzerland).

Relevance

What You Will Learn

In this Abstract, you will learn: 1) Why investing is not rational; 2) The mind, mood and body theory of behavioral trading; and 3) The investing methodology it suggests.

Recommendation

Long time market commentator Woody Dorsey, the theorist behind market semiotics, sees Wall Street as a continuum of the agora or the medieval street fair: a place where people congregate and trade, motivated by their own psychological drives. But if investors are still behaving based on the same visceral emotions that drove exchanges of goats in ancient bazaars, what does that forecast about how the market will act today? According to Dorsey, quite a lot. Interspersed with anecdotes that range from biography to paleontology to horse training, he offers principles and techniques that explain marketplace behavior in a way investors can understand and utilize. Begin with how he scans newspapers, a methodology worth remembering, and continue through his explanation of the Triunity Theory, a new system for understanding behavioral finance. Agree or disagree with his contrarian thinking, *getAbstract.com* believes his interesting diversions and innovative economic thinking will sweep you along. Dorsey brings many subjects together, but the two most interesting are, of course, why people behave as they do and how it affects the market and your money.

Abstract

Triunity Theory

Behavioral economics has been around almost as long as human behavior. Successful traders and investors have always known that there is more to trading and investing than the numbers indicate. However, a strain of rationalism hit the world in the eighteenth century and the contemporary science of economics evolved out of that tradition. Economists, therefore, assume as their starting point that people are rational economic actors seeking to do the things that best advance their self-interest. Thus, they carefully evaluate various possible outcomes and choose the one with the best economic result. The only problem with this way of thinking about people is that it runs directly contrary to much of human experience. People don't behave rationally. There is nothing rational about greed, fear, lust and other powerful, proven motivations for human conduct. Think of market bubbles that send stock prices up far beyond any possible economic justification. Think of the nightly news. There's plenty of evidence that people behave irrationally, but until the advent of the science of behavioral economics, economists tended to ignore this evidence.

"The perpetual dialectic activity between the three brains and the three market functions, Mood, Mind and Body, are what we call Triunity Theory."

The Greek philosopher Plato didn't. He saw man as a triune thing, consisting of emotions, intellect and action. Recent research on cognition and the brain has validated Plato's trinity. Since markets consist of human beings thinking, feeling and acting, it's reasonable to apply a more or less Triunitarian principle to the markets. People have three brains:

- Limbic (Emotional) — Responsible for your feelings.
- Neocortex — Responsible for your thinking.

 © Copyright 2004 getAbstract

- R-complex (Primal) — Responsible for your reptilian instincts.

The Triunity Theory of the market looks at the market analogously:

- Mood — The emotional factors in the market: optimism, pessimism, fear and so on.
- Mind — The conceptual conditions of the market, expressed by market fundamentals.
- Body — The prices in the market, expressed by technical market factors.

"In listening to Soros, Greenspan and Rubin, what we hear is 'experience' rather than theory."

Frequently, the mind can lead both the mood and the body, as when some overriding investment theme or theory leads investors to bid up prices. One example occurred during the recent market bubble, when the theory of the New Economy led to sharp price hikes for technology and Internet-related stocks. Fed Chairman Alan Greenspan drew attention to the market's mood when he blamed the price rises on "irrational exuberance." Mind, mood and body work together and feed each other. Just follow the course of the market's descent from euphoria to despair in the Seven Stages of a Bear Market:

1. Mania — Peak of Dot-com Bubble, December 1999.
2. Denial — After falling sharply, the market rallied in summer-fall 2000.
3. Hope — Though the market fell again, it rallied back in summer 2002.
4. Recognition — The market plunged after the 9/11 terrorist attacks in New York.
5. Reprieve — The market rallies steeply (forecast).
6. Liquidation — The market sells off and slides definitively (forecast).
7. Capitulation — The market bottoms (forecast).

"The stock market is illogical."

Rational economic analysis cannot account for this type of trading pattern. It cannot justify or explain why prices rise to historic heights one day and plunge to historic lows the next, with no apparent change in economic conditions or circumstances. Bubbles and crashes are equally inscrutable to the economic rationalist. According to rational economic analysis, markets are efficient and rapidly incorporate new information into prices; therefore, prices only change as a result of new information flowing into the market. But analysts are at a loss to explain what new information might have accounted for the Crash of 1929, the Crash of 1987, the Dot-com Bubble or its aftermath. That is why behavioral analysis is supplanting old-fashioned rational analysis, and why no one accepts a pure efficient market theory anymore. Such economic leaders as speculator/philosopher George Soros, Greenspan and former treasury secretary Robert Rubin have all spoken of the importance of emotional and psychological factors in the market, not just classic economic ones.

Mind

What is the Mind of the market? What does the market think? How do you find out? The essence of the market's mind is the Investment Theme. Since investment themes come and go, pass and change, we call them Transient Investment Themes. These Transient Investment Themes may find expression in slogans, such as "New Economy," but not always. Transient Investment Themes are explanations offered for the market's conduct. You see them offered in the financial pages of the newspaper and hear them on the radio in expressions such as: "The Dow-Jones slipped because of concerns about the bombing in Madrid," or "The market rose as hopes of an economic recovery…"

"Although behavioral finance is all about heuristics, few have made the connection to human addiction."

When people repeat an explanation often enough, they may begin to believe it, and a theme then becomes an obsession. The theme doesn't have to be true to be effective; it merely needs to be believed. Whatever the theme, people tend to react the same way, over and over. The market is a story, or a drama that follows the same pattern repeatedly.

 © Copyright 2004 getAbstract

"At the price bottom, there is a sentiment impulse followed by a steeply rising sentiment slope."

People use an optimistic theme to explain optimism, and when they hear the theme repeated, it reinforces their optimism. As they get more and more optimistic, the theme seems more and more right, and the sense that it is right justifies more optimism. Then something changes. Maybe a few people get scared. Maybe people just recognize that they've let optimism carry them away. Prices break and fall. What do people do? They come up with a pessimistic theme to explain the break in prices. Because the theme is plausible and prices did indeed break, they repeat it. The more people hear the theme repeated, the more they try to sell and the farther prices fall. The farther prices fall, the more pessimistic people become. At some point, something changes. Maybe a few people recognize that they've let pessimism carry them away. Prices rise and someone comes up with an optimistic theme. The whole cycle repeats.

One useful notion in the analysis of the market's mind is the meme. As defined by the memetic Lexicon of the Principia Cybernetica Web, a meme is, "A contagious information pattern that replicates by parasitically infecting human minds and altering their behavior, causing them to propagate the pattern. Individual slogans, catch phrases, melodies, icons, invention and fashions are typical memes." Memes are like genes. There is a kind of "memetic selection" similar to Darwinian "genetic selection." How do memes spread? Two factors are quite important:

- Membots — A membot is a person obsessed with spreading a particular meme. For example, members of certain religious cults devote themselves to spreading the information pattern of the cult.
- Vaccine — A component of a meme that prevents attack by other memes.

"The market, just like a dramatic production, repeats itself over and over again."

Every Investment Theme begins with some strange anomaly, just as every fashion craze seems to begin with some weird, fringe affectation. Then the meme diffuses through the market in a lifecycle roughly following these stages:

- Innovation — The birth of a meme.
- Discovery — Early adopters take up a meme.
- Buzz — People begin to talk about the meme.
- Coverage — The meme spreads from the early adopters to the mainstream.
- Slogan — The meme peaks.
- Token — Late adopters take up the meme.
- Uncool — The meme loses its credibility.
- Passé — The meme is discredited, old-fashioned.
- Camp — The meme is a self-mocking, ironic statement. Hey, that means it could begin to be fashionable again!

Mood

How do you know when the market is feeling moody? One way is to follow the media. Not follow it in the sense of believe it, but rather follow it in the sense of watch it closely and then act astutely contrary. The newspaper does not provide information; instead, it provides disinformation. A newspaper shapes the thinking of its audience. Different people swear by different papers. Among the most important are *The New York Times*, *The Washington Post*, *The Wall Street Journal* and *The Financial Times.*

"History, from Plato to the Pope, shows that spin pervades all culture."

How do you as an investor use these papers? First, look at the front-page photograph. The front page aims to grab attention. Then scan the front-page overall. Look at what jumps out, what your eye focuses on. Does the face in the photograph smile or frown? Is the text

© Copyright 2004 getAbstract

full of positive words or negative words? Calculate the number of positive and negative words or images. Calculate the ratio of positive to negative. Be a "financial *flaneur*." A *flaneur*, in French, is someone who hangs around watching and making comments on what he sees. Find ways to express the spirit of what you see in the news.

Body

Price is the body of the market. You can see a lot in the chart of prices, but people often miss what they see. Take an example from another field of study. In 1991, someone discovered a frozen, ancient cadaver in the Alps. Although the corpse was on Italian soil, researchers took it to Austria's University of Innsbruck where scientists analyzed, X-rayed and studied the cadaver until 1998. They couldn't figure out what had caused the death of a man who was strong and in the prime of his life. But the Austrian scientists eventually decided that the so-called "iceman" must have slipped, fallen, broken his ribs and then died. By this time the Italians demanded the return of their cadaver. The corpse came back to Italy, where researchers at General Regional Hospital in Bolanza took new X-ray photographs. Clearly visible on the X-rays was an arrowhead in the shoulder of the cadaver. Hmm. Why hadn't the original researchers noticed this? No one knows, but they didn't.

"Cognitive science concurs with what the ancient thinkers have told us."

This kind of thing happens in the market too. Not the discovery of ancient, frozen cadavers, although an argument might be made for that, but people ignoring the obvious and searching for a subtle unknown. Efficient markets theorists believe that stock price moves are random reactions to new information and not the consequence of a repeating drama of mood and mind. They, therefore, believe that charts of stock prices contain no useful information, or very little. In fact, though, some very astute and successful investors rely on charts. Used with discipline, the chart of stock price moves can be a very useful tool. Of course, it is important to avoid the distraction and be aware of optical and cognitive illusions. That said, market price moves do repeat themselves. It's clear for example that a market bottom may precede a "secondary low" almost but not quite as low as the bottom. The secondary low, in turn, precedes a rally. It happens over and over again. Remember these principles about technical analysis and price moves:

- People learn to see and see what they have learned (and been taught) to notice.
- Always examine what you see and why you see it.
- There are patterns in market price moves.
- Good traders who understand behavior trade on the patterns.
- Everything repeats: emotions, investment themes and price moves.
- Investors make the same errors repeatedly and the astute trader profits.

About The Author

Woody Dorsey began publishing his market commentary in 1985. He lives in Vermont.

 © Copyright 2004 getAbstract