Minding the Markets

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An Emotional Finance View of Financial Instability

David Tuckett

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Preface

The ruinous financial crisis of 2008 has provoked many words, but not enough change, in the way financial markets are organised, in the way we understand them in economics, and in the way they are regulated. Greed, corruption, trade imbalances, regulatory laxity, and panic, all frequently cited as causes, do not create behaviour on their own. At the heart of the crisis was a failure to understand and organise markets in a way that adequately controls the human behaviour which financial trading unleashes. What happened in 2008 and the period before required judgements made by many human beings subject to human psychology. It is these judgements in the institutional context in which they are made and how they combine to produce crisis that this book aims to understand.

I spent much of 2007, just before the crisis, conducting a series of detailed research interviews with senior financiers in Boston, Edinburgh, London, Paris, New York, and Singapore. It is what they told me about the context of their decision-making and the judgements they had to make which I present in this book. Their responses suggest that traditional economic approaches, including the recent development of behavioural economics, do not capture the essence of what happens in financial markets and why they produce crises.

Taking the uncertainty my respondents described as the major experience in financial markets, I offer an alternative way of understanding the markets, which prioritises the role of narrative and emotion and the way they influence judgement in social context. Based on my observations, I find that financial markets necessarily create dangerously exciting stories, problematic mental states, and strange group processes in which realistic thinking is fundamentally disturbed. From this position I will argue that, as currently organised, financial markets are inherently unstable. I will also suggest we can make them safer only if we understand how and why financial assets unleash powerful emotions and stimulate narrative beliefs which disturb human judgement.

Unfortunately, despite the catastrophic nature of the crisis and its ongoing effects currently felt in nervous sovereign bond markets and massive government cutbacks, there are strong signs of a tendency not to learn from what has happened and to return to business and even understanding as usual as quickly as possible. To put an end to understanding as usual, and to suggest ways forward, is the main aim of this book. In the final chapter I will suggest that those who work in key positions in the financial network and those who regulate financial markets need to try to work together to conduct a nonpunitive enquiry into what happened leading up to 2008 along the lines of what was done in South Africa post-apartheid. To make financial markets and the behaviour within them safe there is a need to learn from experience and to see that a very different kind of regulation and self-regulation than what we have had is necessary.

Core concepts

There has been a growing recognition in economics as in many other sciences that emotion matters much more than has previously been thought. But the way it has been included in economic thinking so far does not do justice to the phenomenon. The theoretical innovation offered in this book is to set out the role of varying mental states and their impact on thinking processes to show how they can systematically modify preferences, expected outcomes, and decision-making in a dynamic and path-dependent but nonlinear way.

The core concepts I have developed to use in this book cannot be defined and expressed in the precise and elegant way used in mathematics. They are complex and need to be lived with and internalised. They will be elaborated (particularly in Chapter 3 pp62–65 and 65–70) so that their full meaning is much clearer by the end of the book. But meanwhile here are some simplified working definitions:

Uncertainty: *Used only in the sense described by Knight (1921) and Keynes (1936), recognising that ultimately we cannot know what will happen in the future.*

Unconscious Phantasies: *The stories (saturated with emotion) we tell ourselves in our minds about what we are doing with other people (and "objects") and what they are doing with us, of which we have only partial awareness.*

Object Relationship: *The affective relationships of attachment and attraction we establish in our minds with "objects" – that is, people, ideas, or things, of which we are only partially aware.*

Phantastic Object: *Subjectively very attractive "objects"* (*people, ideas, or things) which we find highly exciting and idealise, imagining (feeling rather than thinking) they can satisfy our deepest desires, the meaning of which we are only partially aware.*

Ambivalent Object Relationship: *A relationship in our minds with an object to which we are quite strongly attracted by opposed feelings, typically of love and hate, of which we are only partially aware.*

Divided State*: An alternating incoherent state of mind marked by the possession of incompatible but strongly held beliefs and ideas; this inevitably influences our perception of reality so that at any one time a significant part of our relation to an object is not properly known (felt) by us. The aspects which are known and unknown can reverse but the momentarily unknown aspect is actively avoided and systematically ignored by our consciousness.*

Integrated State: *A state of mind marked by a sense of coherence, which influences our perception of reality, so that we are more or less aware of our opposed ambivalent and uncertain thought and felt relations to objects.*

Groupfeel: *A state of affairs where a group of people (which can be a virtual group) orient their thoughts and actions to each other based on a powerful and not fully conscious wish not to be different and to feel the same as the rest of the group.*

I propose that when investors buy, sell, or hold all classes of financial assets they are understood as establishing ongoing and unconscious *ambivalent object relations.* In their simplest form, object relations are stories told in the mind. They are representations of the imagined emotional relationship between subject and object which produce good and bad feelings – for example, I love him, he likes me, I hate her, they make me anxious. Most object relations are somewhat ambivalent because emotional relationships are often conflicted – I love *and* hate him, I want to be part of that group and away from it, and so forth. Sometimes the conflicts are so powerful they are too unpleasant to know. In the state of mind that I will elaborate later and which I call *divided,* conflicting representations of relationships to an object are present in the mind but not consciously experienced and so not available for thinking – the relationships are not all conscious. One moment the relationship may be consciously felt as only loving and the next only hating, although it is actually both. The theoretical potential of a *divided state* is that it highlights the potential for what economists might consider as preference reversals. In a divided state, a relationship may unpredictably move from all loving to all hating or all hating to all loving. This is observed frequently in personal and work relations and in the relations professional investors have with assets in financial markets. A *divided state* contrasts with an *integrated state* in which conflicts are more or less known along with the uncomfortable feelings they create and so can be thought about. *Integrated* states are therefore not only more realistic and stable but also more emotionally challenging. *Divided* states are adopted partly because emotional conflicts can be intolerably frightening or frustrating.

As far as I am aware the potential importance of *ambivalence* and its effect on economic life was first noted by Neil Smelser in his presidential address to the American Sociological Association (Smelser 1998). He took the idea from Freud just as the general idea of object relationships derives from Freud's earliest psychoanalytic formulations (Freud 1900). Although Freud's thinking has been pronounced dead by many who have never read him, there is now substantial cross-disciplinary research, particularly in the field of attachment (Mikulincer and Shaver 2007), which backs his insight that relationships to people and things are represented in the mind consciously and unconsciously on an ongoing basis, are invested with desires and feelings, and have a major impact on attention and thinking. Evidence will be discussed in Chapter 3 (pp59–62) that an almost continuous interchange is observable between those parts of the brain concerned with primitive affects (like trust, anger, and sexual attraction) and those with "higher" cognitive functions. This interaction forms the substrate for all thinking and decision-making. There is also little observable difference between the observable brain events which accompany real and imaginary scenarios (Damasio 2004).

The core concepts I have mentioned above have their origin in a time when I became interested once more in economics and in what happens to human judgement in financial markets after a very surprising and in fact disturbing afternoon in March 1999, around the height of the dotcom bubble.

I was then editor of the *International Journal of Psychoanalysis* and an honorary director of a small US electronic publishing company. As a charitable scholarly venture we had recently archived many of the key works in psychoanalysis and distributed them modestly successfully to colleagues worldwide on a CD. I was, therefore, very surprised to find myself invited to sit down that afternoon with two rather excited people who wanted to pay several million dollars to purchase the business from the U.K. and U.S. charitable institutes who had financed it and also to offer my colleagues and me ongoing and significant sums as advisers. Their idea was to help to develop the company and then offer its shares to the public as what they thought could be a very successful "dotcom". One of the two men was a very experienced and successful venture capitalist working for one of the most prestigious London investment banks. Although he and his colleague knew very little about psychoanalysis or electronic publishing they thought our business model, expertise, and search technology could transplant to other disciplines. In fact over several weeks and some fascinating and exciting meetings, we eventually worked out that our venture did not need to take on any debt and could fund its development from its own revenue streams. We, therefore, said no – to the significant sums and to the excitement. The company survives and prospers today as a U.S. not-for-profit. The incident left me curious.

As well as being a psychoanalyst, I had undergraduate and graduate training in economics and sociology. The question for me was how such very able and experienced people could have been so excitedly convinced they "had" to own a dotcom, and then expected to make a great deal of money by floating it off – bearing in mind they knew little about psychoanalysis, publishing, or the new Internet method of product delivery. As the bubble shortly collapsed and most of these new enterprises became worthless I came to realise something it seems had hitherto been known, but, in fact, ignored. Whatever else goes on in an asset price boom and bust, it looks primarily like an emotional sequence. From a clinical psychoanalytic viewpoint it is a well-known and path-dependent emotional sequence of *divided* states – in which unrealistic manic excitement takes over thinking, caution is split off, and there is huge and even violent resistance to consciousness of many signs of reality. Because reality is unconsciously divided off from experience, the state can persist for a long time but will inevitably collapse into panic and paranoia before blame becomes dominant. At this final stage learning is unlikely unless the whole experience can be integrated and loss worked through.

Looked at more closely through the lens of the detailed descriptions available (Mackay 1848; Galbraith 1993; Kindleberger 2000; Shiller 2000), it seemed to me that asset price bubbles occur because a story gets told about an innovative object of apparent desire (such as a dotcom share, a tulip bulb, or a complex financial derivative) which becomes capable of generating excitement in a situation where outcomes are inherently uncertain. The story ushers in *divided* state–object relationships to the underlying reality and thinking processes about that reality become dominated by what I will call *groupfeel*[1].

In discussion with Richard Taffler, I coined the term *phantastic object* to cover the situation (Tuckett and Taffler 2003, 2008). The term conjoins "phantasy" as in unconscious phantasy and "object" as in representation and is elaborated in a later chapter. The phantasy stimulated is about much more than just a story of getting rich. Rather it is a story about participation in an imagined object relationship in which the possessor of the desired object plays with the omnipotent phantasy of having permanent and exclusive access to it and all good things. Tom Wolfe describes the story in *Bonfire of the Vanities* and Michael Lewis in *Liar's Poker*. Aladdin had a lamp and the Emperor his new clothes. Taffler and I went on to suggest that this concept could have wide applications and form the basis of what Taffler christened Emotional Finance (Taffler and Tuckett 2007).

After using my interview material to describe the way my respondents set about the task of buying, selling, and holding assets in the everyday situation of uncertainty they experienced, I will suggest financial markets always have the potential to embrace stories about *phantastic objects* and to be overtaken by *divided states* and *groupfeel*. In the years leading to the 2008 crash it was financial derivatives which became experienced as *phantastic objects,* and, after leading to *divided* emotional states and *groupfeel,* produced a catastrophe.

The central point, it seemed to me when I looked at asset price bubbles, was that in every case once the "story" that there is a *phantastic object* gets about and gains some acceptance, there is *groupfeel*. Uncertainty then disappears, thinking is disturbed, and the intense excitement being generated compromises judgement. The lack of uncertainty begs the question where it has gone, which was why the concept of a *divided* mental state seemed useful. It captures the emotional relationship to reality that has become dominant and helps to explain how an infected group feel free from doubt – how those in it become able to conduct a compelling love affair with the idea that the phantastic object has changed the reality of the world. Understanding this as *groupfeel* within a *divided* emotional state also helped to explain why normal caution about risk-taking is always so confidently "split off" (not thought) and alternative views so dismissively lampooned as out of date. It also made sense of the ease with which behavioural rules (such as prudential ones about bank capital requirements or bond-rating assessments) were always altered without too much fussy thinking so that what will later be recognised as excessive risk-taking and excitability become normal. It also seemed to explain why the significant sceptics who doubt or criticise what is happening gain no traction and are invariably dismissed, ignored, greeted with derision, or even threatened. Warren Buffet, for example, warned that financial derivatives are "financial weapons of mass destruction" (Buffett 2003 p14).

Narratives and mental states

Research can be topic oriented or discipline oriented (Gigerenzer 2008 p*v*). The aim of my research is topic oriented: to understand how and why financial markets become unstable using whatever we know. By contrast and particularly for the past 60 years, economics has tended to be a normative discipline pursuing a specific analytical paradigm using a relatively narrow range of methods. To a considerable extent these norms have been powerfully enforced, to the extent that when major new insights have been incorporated – such as Simon's ideas about the limits to rationality or more recent ideas about the role of cognitive and emotional processes – this has happened within very strict limits (Gigerenzer 2008 p85 et seq). Behavioural economists have actually gone so far as to emphasise rather apologetically that their aim is to improve the field of economics "on its own terms" modifying "one or two assumptions" that are "not central" (Camerer, Loewenstein et al. 2004 p4). This has gained them only some acceptance.

Change for its own sake has little point. But if economics is to reach an adequate understanding of financial instability and its important consequences for human welfare, my findings suggest a much more significant engagement with other social disciplines is required as well as a significant shift both in methods and analytical frameworks (see also Akerlof and Shiller 2009; Akerlof and Kranton 2010).

The core concepts I have just introduced come from standardised interviews in the field with seasoned professionals, not laboratory experiments with psychology or economics students and not questionnaires administered to samples from whole populations. In Chapter 9, I will explore how my concepts have implications for the core theory of motivation used in standard economics in which individuals "make choices so as to maximise a utility function, using the information available, and processing this information appropriately" (della Vigna 2009 p315). At the same time I will stress that unless altered beyond recognition I think they cannot be captured by introducing one or two modifications into the conventional utility function.

The main reason for insisting on difference is because, when I interviewed them, the situation I found my respondents describing was fundamentally uncertain. Typically modern economists carefully define what I have in mind as Knightian uncertainty (Knight 1921), and distinguish it from risk. They then spend a lot of time discussing risk (known unknowns) and seem to ignore uncertainty. But Knightian uncertainty (unknown unknowns) makes all the difference. In that context, for instance, logico-deductive-based thinking and prediction of the kind enshrined in probability theories (and then modelled by economists as rational decision-making and optimisation under constraints) may be worth using but may also be of limited value and perhaps not even rational at all. Trying to work out what to do when the relationship of past and present to future is uncertain is not the same as dice-throwing or playing roulette.

My respondents were not trying to predict runs of dice or wheels and balls. These are the wrong analogies for what almost anyone interviewed in a financial market is trying to do. Rather, what my financiers described to me was trying to decide what they thought were the various uncertain futures that might unfold for the future price of various financial assets. To do this they looked at (made guesses about) what they thought would happen and its likelihood, what others thought, what others were doing, and what everyone would do in future. They used every method they could to think of to determine what to buy, sell, or hold and they also thought about the responses in the social-institutional situation in which they found themselves – what others would think if they did this and that happened, or, if not, what would be the particular outcomes and what would everyone feel about them?

Interviews quickly revealed the decision context just mentioned and so a significant consequence of a suppressed premise in economic thinking – namely the practice of treating all kinds of markets for all kinds of objects as essentially the same. As I mention in Chapter 2 (p27), even in the first pilot interview Richard Taffler and I did of a senior asset manager in 2006, I was forced to realise very rapidly that financial assets were not like other goods and services and to treat them as such was likely to be in error.

In the first chapter (p19), I will describe the three crucial and inherent characteristics of financial assets I found influencing the judgements of those I interviewed. First, they were volatile, meaning that they could easily create excitement at quick reward or anxiety about rapid loss. Second, they were abstract, meaning that they are not concrete items that can be consumed but are symbols that have no use in and for themselves, so that their value today is entirely dependent on their possible future value and that value is fundamentally uncertain and dependent on the reflexive (Soros

1987) expectations of traders. Third, that when trading them rigorous evaluation of which aspects of performance are skill and which are luck is not really possible. These three facts and the uncertainties they introduce meant that it was far from rational to value financial assets (and financial performance) only by calculating risk and probabilistic returns in the way economics and finance textbooks suggest. Rather, to make decisions in the context they inhabited, my respondents had to organise the ambiguous and incomplete information they had into imagined stories with which, if they believed them and were excited enough by them, they then entered into an actual relationship which had to last through time.

Understanding the function of narrative in human minds and how it works in everyday life will be reviewed from the viewpoint of psychology, psychoanalysis, and cognitive neuroscience in Chapter 3. Its importance has begun to interest economists (Akerlof and Shiller 2009). Narrative is one of the important devices humans use to give meaning to life's activities, to sense truth, and to create the commitment to act. Although its procedural logic is different from that in logico-deductive reasoning, it is not necessarily inferior to it – particularly in contexts where data is incomplete and outcomes are uncertain (Bruner 1991).

The fact that their value can go up and down a lot means that financial assets instantly provoke the most powerful human desires and feelings – excitement and greed around possible gains, and doubt, envy, persecuted anxiety, and depression about potential loss. Such feelings are not just dispositions in a utility function. They influence managers' daily work in an ongoing dynamic way and also affect the responses to them of their clients and superiors. In particular, holding an asset takes place through time and creates experience which can disrupt or confirm a story. News, therefore, creates emotion and so particularly do price changes. Price in a financial market functions as a signal. As new information which might threaten the future of the "story" emerges, the holder of a financial asset has to be able to tolerate his worries as he watches his cherished investment fall in price and wonder why. She/he knows there may really be good reason to rethink and sell but does not know for sure. This characteristic of financial assets means that in effect the original decision to buy has to be made again and again and again for as long as one holds the stock – a point, missed by current economic theory, which, as discussed in Chapter 1 (p20), is strangely static in its treatment of time.

Such facts about financial assets are the reality context. They place severe limits on even the most ingenious actor's capacity to make decisions. They make it unlikely that all reasonable agents will draw the same conclusions even if they have the same data. Because my financial actors were not able to see the future with certainty, their thinking about the value of securities was saturated with the experience of time, the memory of past experience, experiences of excitement and anxiety and of group life, as well as the stories they told themselves about it all. From this perspective, rather than describe financial markets as trading in probabilistically derived estimates of fundamental values, as in the standard text books, I will suggest they are best viewed as markets in competing and shifting emotional stories about what those fundamentals might be – but with one version or another of the story and its emotional consequences getting the upper hand at any particular time and for some of the time.

The Organisation of this book

Chapter 1 is devoted to a brief review of what we know about what happens in financial crises (including the last one) and how economists explain it as well as to an elaboration of the special characteristics of financial assets. The next chapter introduces my study method by describing what four of the asset managers told me and shows how, by using interviews, my main hypotheses about uncertainty, *ambivalent object relations*, telling stories, *groupfeel,* and mental states emerged from the data. In Chapter 3 I look at what modern cognitive, biological, and social science has established about narrative, groups, and emotional mental states. The next five chapters describe the main findings and elaborate on the concepts discussed above. Chapter 9 then sets out the core elements of emotional finance as a new theoretical approach to the economics of financial markets, showing how and why normal markets are at risk to turn into financial crises at any time. Finally, Chapter 10 looks at what we can do to make markets safer.