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Section: Opinion

Opinion: Psychological Dynamics in a Madoff Made-Up World

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Amid the disgust over Ponzi's latest appearance courtesy of Bernard L. Madoff, tip-toes the sheepishly answered question of how the professionals got duped. The biggest bank in Spain, Nomura in Japan and BNP Paribas surely should have known better. Shouldn't they?

Presuming humans run the banks across both oceans, they might actually have had less of a chance based on their skills in a Mr. Spock act, the impersonation of making investment decisions totally devoid of all emotion. The ostensibly irrefutable commandment of profitable investing taught them to put capital at risk only after stoic, rational and mathematical analyses. Indeed given the stated returns and relatively benign big-cap, option collars strategy it looked like they were doing exactly that. Alas, they weren't because they can't.

The new science of neuroeconomics, the study of our brain's processes for making financial decisions, together with behavioral research, are amassing revolutionary evidence for the indispensable role of feelings and emotions in analysis and decisions. Therefore, the previously accepted strategy of extracting feeling and emotion in actuality multiplies the true risk. This translates to a huge data gap as a result of Mr. Madoff's apparent craftiness at manipulating the neurological foundation of decisions.

Mr. Madoff, it appears, intentionally exuded the message that he deserved trust. He redeemed funds in a timely manner, gave generously to charity and had his family in the "fund." Those behaviors would have literally injected (the psychological term is induced), beliefs and confidence into the psyche of anyone he dealt with. With that emotional architecture in play, traditional objective decision processes never had a chance.

Feelings, thoughts and actions are at the same time separate and inseparable. Beliefs operate as the connector. They seem like thoughts, they act like feelings and are conscious or unconscious. They also fuel the lifeblood of all markets and every individual investment choice—that "X" factor, the *feeling* of confidence.

Investors believed either they or others were making money. They had statements and witnesses. Add the following brain mechanisms and voilà: matches got lit to billion dollar bills. We tend to expect the same result from the next decision as we got from the last. We forget that the music always stops. This mental shortcut drives bubbles of all types whether they are manufactured on a printer or play themselves out in housing prices, CDOs or dot-com equities.

Second, we focus on data that confirms our beliefs. Feelings and emotions fire faster and before deliberate analytical thinking—like neural air-traffic controllers directing what would otherwise be a chaotic mess of having to file through every item of information one has ever learned. This preferential sequence begets influence over which data will even be up for investigation. This brain trick also misleadingly keeps us feeling safe and smart. Feeling good by definition feels better than feeling bad so we gravitate towards inputs that bolster feeling good about decisions we have already made.

Even if we get an inkling that something doesn't add up, we will be highly inclined to ignore it based on the opinion of someone we perceive as an expert. In any social milieu, the long-time members of the club qualify as experts. Enter Carl Shapiro, the 95-year-old philanthropist who may have lost $500 million, or Big Bank X, the bank in that other major country that competes for the same business.

Ironically at the core of this fraud lies adherence to two unquestioned but incorrect beliefs:

1. Don't involve emotions in investing, and
2. shun negative emotions.

Given that science basically now knows that even reaching for a glass of water is impossible without functioning feelings and emotions, attempting the impossible insidiously magnifies the scenario wherein vital clues go undetected.

Furthermore, so-called negative emotions do in fact provide built-in protection. Fear and even anger, say over not getting straight answers for example, serve as superb risk managers—when their users finish the software training in how to evaluate this type of qualitative data.

And then you have to look at the "Perp" himself. I met him in 1997 when I needed order execution for a trading desk I managed. I remember being surprised that he invited me into his office. Given the size of his organization, I would have expected to deal with a salesperson. In retrospect, his evidently habitual use of the personal touch explains that.

More recently, I heard him speak at The Philoctetes Center in a discussion of the market's future after the violent swings in August 2007. He described developing the Nasdaq and he talked of regularly visiting the SEC. His tone, including a chuckle, communicated the impression that his terms with them were very friendly. Given that government watchdogs must be at least as human as bankers, the feelings he must have left them with would have the same dissuading effect on any effort towards more robust investigation.

For anyone who finds fascination in psychological motivations, he insisted that no one could get away with anything these days because the computers are just too sophisticated. He even said his company used computers to help prevent the inevitable dishonesty in human nature. Was he disingenuously warding off scrutiny or unconsciously telegraphing his activity? Or both?

One thing I do know is that the explanation of greed doesn't cut it. In our work we find that the most powerful emotions operating in traders are *not fear and greed* but fear A and fear B—fear of losing or fear of missing out. Fear of missing out certainly impacted some investors' denial of the flapping red-flags but in Mr. Madoff's case, given that the first reports of complaints stem from 1999, did he get started because his commissions revenues were squeezed while everyone else was legally printing money in the exploding internet bubble? I.e., how could the man who facilitated the tech boom via the creation of a marketplace wherein small tech companies could trade be missing out on its biggest bubble?

He also mentioned being reviled early on for instigating the move to electronic trading. That to my mind also poses some compelling psychological fodder—a guy who at the beginning and apparent end of his career cooks up rejection and ostracism for himself through what looks like the strategic use of popularity ratings. My Spotnitzian-based Modern Psychoanalysts (versus the Freudian types) could have a field day with that!

For investors, analysts and even quantitative traders, the imperative lesson lies in adopting a strategy of emotion analytics that resides on par with model and chart analytics. Ferreting out one's feelings leverages the brain's complete database and uncovers our seemingly default biases. Knowledge of that kind, which is not found in numbers, will direct the research to places logic alone can't find.

We really can't outthink the brain's reliance on feelings. What we can do is proactively pursue awareness of what all our feelings and emotions are signaling.

FDR actually got it wrong. The only thing we have to fear is *NO* fear at all!

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