How Financial News Gets It Wrong

Beware of headlines that claim to explain markets

BY MARSHALL JAFFE
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All of us want to believe that we are objective, dispassionate observers of the world-at-large, and that we can act rationally in challenging times. Unfortunately we are saddled with cognitive, social and psychological biases that limit our ability to navigate through an increasingly complex world. The exponential growth of digital information leaves us barely enough time to read the headlines. As a result it's those headlines that increasingly inform and color our worldview.

Towards the end of last year the issue on every investor's mind was the looming fiscal cliff. The market appeared to be ignoring the headlines, which were getting scarier by the day. One day at lunch I was (literally) cornered by a number of acquaintances. They were visibly concerned and they wanted to know what they should do about the *fiscal cliff*. What did I think? The market was crazy—wasn't it? Should they sell everything, buy canned goods and ammo and move to Idaho? I tried to explain that the apocalyptic narrative running through their heads was driven by headlines, and that narrative was making it impossible for them to realize that there were hundreds of possible outcomes—the most likely of which were probably far more benign.

More recently I was out to dinner with close friends. There were no scary headlines in the news, and there hadn't been any for months. The subject of the market naturally came up because my friends are financial planners—and we have traded ideas for years. They casually asked me if I had heard why the market was up.

As I was in the midst of writing this column, I made what I thought was a convincing case for why no one could really know why the market was up or down. There was a long, uncomfortable moment where they just stared at me, as if we were discussing gun control and I had said, "Well *my* line in the sand is atomic weapons." Then they got their voices back: "You don't tell that to your clients, do you?" "Have you lost your senses?" "Of course we can know why the market rose or fell—it's in the news every day." Since they are good friends, they didn't go too far in their condemnation. But they were confident in their belief that I was the one with reality issues.

Between these two anecdotes, you would think that the first one was far more important than the second. The dramatic subject of the headlines, the very real economic threat and the emotional state of my friends make it seem far more consequential and significant than the second. But if you concluded that, you would be incorrect. The implications of the second story are far more important and far more dangerous, because the result is a perversion of investors' fundamental understanding of what markets are, how they work and ultimately how to invest.

Headline Risk

The headlines my dinner partners were referring to are so common we rarely give them a second thought: *Market Drops on Disappointing Jobs Report; European Leaders' Agreement Fuels Market Rally; Markets Mixed in Anticipation of 1st Quarter Earnings*. The impact of each one is close to zero. But over time, the days, weeks, months and years of reading them, the impact is powerful. And while we would be hard pressed to remember any particular one, what we do remember—what becomes part of our reality—is that *something* was moving the market, and that something was reported. This gives us a sense of comfort: that there is an identifiable reason the market goes up or down, and that information can be known.

And what exactly is this *market* thing that goes up and down? It's not a place, it's not a being and it's not a *thing*. The market is a *process* (an incredibly useful one) that easily and accurately aggregates the daily buy-and-sell actions of millions of investors. I like to think about the market as the world's greatest bookie: the master of masters who can distill all the information in the world into what's relevant and what's not, and then discount all of it quickly and efficiently into thousands of individual and relevant prices.

We get to see only the results—our market bookie doesn't reveal what news he's discounting or what is driving investors to buy or sell. But we still want to know.

The financial news industry is geared to a serious and demanding audience. A publication's integrity is critical to its influence and popularity. The *New York Times*, *Bloomberg*, *Wall Street Journal*, *Reuters*and the *Financial Times* represent journalism at its best, dedicated to checking their facts carefully before reporting to their readership. But they also have an audience that wants to know why the market is moving; and they would have to be in some kind of self-destructive mindset not to give their readers what they're demanding.

The reporters who fulfill this daily "need to know" have sources that are reliable, experienced, and connected—and whom they contact regularly to get a sense of what important news might be impacting the market. But as one reporter related to me, they are not conducting a full blown "investor poll" each day; no media source could justify the budget needed for that kind of undertaking. It's simply an educated guess.

That is why each day we can read what the logical and easily understandable reason was for the market's behavior. And when the market appears to act in a way that is not easily understood, market commentators will inform their readers that there is now a "disconnect" between the market and (take your pick) the economy, consumer confidence, corporate profits, whatever. The implicit message is that there *should be* a connection between the market and some selected news items—a complete contradiction of how efficient markets operate. But over time the investing public and a considerable number of experienced professionals have internalized the message of the daily headlines and the result is that this "truth" is now assumed and unquestioned.

Reality Test

Deeply entrenched misperceptions—ones that are reinforced daily and play to cultural or instinctive biases—are particularly destructive because they pervert an investor's sense of reality; and within that alternative reality the investor is making what he firmly believes are rational choices.

There is no easy solution to this. Pushing up too hard against popular beliefs (even if they're delusions) is a risky business. Fortunately, investing is one of the few places left where facts and truth really matter, and so that's where we have to draw our line in the sand. The daily headlines and the misperceptions they foster are not going away anytime soon. But neither are the indisputable facts that form objective reality. All we need to do is use them as guides to regularly inform our choices and our world view. With time our clients will follow.