Seasons change, markets fluctuate and so often, we overreact

Have you ever unnecessarily whipped out your winter coat on the first cool day of autumn, or left without one on the first sunny day of spring only to spend an evening shivering outside? It can be tempting to overreact to change, something we see in responses to stock market volatility

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In or out

Market prices often move suddenly and with little warning. In early February—after a long period of steady gains and very low volatility- the Dow Jones Industrial Average plunged more than 1,000 points in a single day, the largest point drop on record. A similar move was recorded just days later.

Such sharp gyrations are clearly unnerving for investors and can raise questions about the benefits of active investing.

The efficient markets hypothesis - suggests that markets are, in fact, rational. The theory goes that stock prices fully reflect all publicly available information and move only in response to unanticipated events, therefore fluctuating randomly over time. By extension, the EMH suggests it is impossible to 'beat' the market and that passive trading may lead to longer-term market gains.

Still, critics of this argument say it understates the role of emotion in decision-making. Welcome, behavioural economics -- and our human approach to market movements.

We are human

Change can be exciting but getting caught up in the moment can mean we put too much weight on recent news. President Trump's continually updating Twitter feed or Facebook's changing stock price can distract market watchers from the bigger picture.

An undue focus on new information can result in over- or under-confidence in what these changes mean. When the market goes up, it's normal to be optimistic about future prices, thinking they will continue to increase. Conversely, when share values are going down, we can become overly pessimistic. We also actively look for ways to confirm that our biases are justified when instead, we should objectively evaluate what the market is likely to do next.

Our emotional responses often mean that prices increase more than they should when good news is released and fall excessively on bad news. While volatility may erode over time, it can lead to extreme events like those seen earlier this year.

Greed and fear can also affect confidence and induce our dominant 'animal spirits', driving an appetite for risk and influencing how willing we are to actively participate in the stock market. Our fear of missing out on the next big thing can spur incredible bubbles, like the internet boom in the late 1990s or the Tulip mania in the early 1600s, while our fear of losing money can lead to widespread panic-selling.

Following the trend is comfortable and not always the right move. But leaving the market at a price drop because other people are also selling can make sense in many cases. As behavioural finance expert Terrance Odean explains, a lot of investors sell because they are afraid others will do so first, leading to an overreaction in the market.

What to do

The challenge for investors is how to acquire enough information to make calculated decisions and be able to identify price changes based on irrational responses before reacting to them. One way to shield yourself from dramatic price swings is to shun the herd and avoid the siren call of conformity.

Another is to diversify your investments so changes in the price of individual stocks have less of a total impact on the value of your assets.

Taking a longer-term view can also be useful but plan to react when needed. If there is an opportunity in the market, things can move fast: being late to the table may mean a wasted journey.

Remember, the stock market has no memory, whatever you do. Think like a human, learn from experience and apply what you know.