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Words of comfort for the grieving investor

John Kay

Elizabeth Kübler-Ross, a Swiss doctor who worked with the terminally ill, analysed characteristic human reactions to loss or bereavement. Her approach, used today by counsellors around the world, also describes how people behave when dumped by their partner, when they are fired and when they lose their wallets. The analysis is also relevant to market responses to financial blow-outs, from the South Sea bubble to the structured debt crisis.

The first stage is one of shock and denial. "You can't be leaving me!" "We're still dancing," said Chuck Prince, unaware that this was his last waltz: those who remember Walter Wriston's comment that "countries can't go broke" will realise that a gift for the memorably unfortunate phrase seems a necessary requirement for the top job at Citigroup.

Shock and denial is followed by anger, as victims seek someone to blame for their misfortune. The anger of the jilted lover or sacked employee has an obvious target: the ill or bereaved must just be angry with the world. The financial community can point the finger at central bankers, or their regulators: the function of the state is to have the prescience we lack and the resources to save us from our own mistakes.

It is always useful to find scapegoats, such as Stan O'Neal from Merrill Lynch and Chuck Prince. Worse will follow: no bubble ends without a few men moving from boardroom to prison. Some still believe that the travails of the market in the wake of the dotcom bubble were not the consequence of a decade of corporate excess, but the fault of a few corrupt individuals.

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In the present credit crunch, most people are still at stages of denial and anger. They are reluctant to accept that the demand for structured products generated a supply of irresponsible credit across all sectors of the world economy and attribute the problems to bad lending practices specific to US subprime mortgage markets. They espouse the theory of the few bad apples, aggravated by the failure of regulators.

But others are already moving on to the third phase. The victim tries to bargain. Perhaps we can still be friends. Many religious edifices have been constructed by those who promised God a favour if only they were spared. The faltering superfund is the first element in the process of negotiation. Not necessarily a hopeless one: while praying for deliverance from plague or tempest is usually futile, man-made perils can often be diminished through bargaining.

But the outcome of such a process is rarely adequate to stave off depression, the fourth phase. Depression in individuals is often associated with apathy – pointless inactivity. Depression in companies is more commonly associated with pointless activity: recrimination, restructuring and layoffs. But depression gives way to acceptance. The bereaved build their new lives, the once disconsolate find new partners. The irrepressible ingenuity of the financial services industry finds new products to sell to a new generation of punters.

Sometimes the stages follow each other rapidly. The Northern Rock saga evolved in short order from denial through anger and is now in the bargaining phase. Negotiation might produce a resolution: if not, the institution will pass quickly into phases four and five. The aftermath of Japan's asset bubble, by contrast, was a depression that lasted a decade; while the American temperament seemed to allow the dotcom bubble aftermath to pass from anger to acceptance much more quickly.

But most counsellors believe that evolution through the phases of grief must be allowed to take a natural course. Individuals find acceptance at their own pace and so will the market. The effective adviser can only watch supportively – the commonest mistake in handling crises of loss is to respond to anger or negotiation. The wise advice to the observer, hard to follow, is to do and say very little.

So it is for successful investors. Perhaps the most difficult of investment lessons is that inaction is often the best action. I do not think Kübler-Ross aimed to recommend financial strategies. But sell on denial, buy on depression, is the clear implication of her analysis.

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