Herd Behavior

Psychology of an Investor

One of the most infamous financial events in recent memory would be the bursting of the internet bubble. However, this wasn't the first time that events like this have happened in the markets.

How could something so catastrophic be allowed to happen over and over again?

The answer to this question can be found in what some people believe to be a hardwired human attribute: herd behavior, which is the tendency for individuals to mimic the actions (rational or irrational) of a larger group. Individually, however, most people would not necessarily make the same choice.

There are a couple of reasons why herd behavior happens. The first is the social pressure of conformity. You probably know from experience that this can be a powerful force. This is because most people are very sociable and have a natural desire to be accepted by a group, rather than be branded as an outcast. Therefore, following the group is an ideal way of becoming a member.

The second reason is the common rationale that it's unlikely that such a large group could be wrong. After all, even if you are convinced that a particular idea or course or action is irrational or incorrect, you might still follow the herd, believing they know something that you don't. This is especially prevalent in situations in which an individual has very little experience.

Follow the Herd?

Herd behavior was exhibited in the late 1990s as investors were frantically investing huge amounts of money into internet-related companies, even though most of these dotcoms did not (at the time) have financially sound business models. The driving force that seemed to compel these investors to sink their money into such uncertain ventures was the reassurance they got from seeing so many others do the same thing.

A strong herd mentality can even affect financial professionals. The ultimate goal typically of a money manager is to follow an investment strategy to maximize a client's invested wealth. The problem lies in the amount of scrutiny that money managers receive from their clients whenever a new investment fad pops up. For example, a wealthy client may have heard about an investment gimmick that's gaining notoriety and inquires about whether the money manager employs a similar "strategy."

In many cases, it's tempting for a money manager to follow the herd of investment professionals. After all, if the aforementioned gimmick pans out, his clients will be happy. If it doesn't, that money manager can justify his poor decision by pointing out just how many others were led astray.

The Costs of Being Led Astray

Herd behavior, as the dotcom bubble illustrates, is usually not a very profitable investment strategy. Investors that employ a herd-mentality investment strategy constantly buy and sell their investment assets in pursuit of the newest and hottest investment trends. For example, if a herd investor hears that internet stocks are the "best" investments right now, they will potentially free up capital from a diversified portfolio to concentrate on internet stocks. If biotech stocks are all the rage six months later, they will probably move their money again.

Keep in mind that all this frequent buying and selling incurs transaction costs, which can eat away at available profits. Furthermore, it is extremely difficult to time trades correctly to ensure that you are entering your position right when the trend is starting. By the time a herd investor knows about the newest trend, most other investors have already taken advantage of this news, and the strategy's wealth-maximizing potential may have already peaked. This means that many herd-following investors will probably be entering into the game too late and are likely to lose money as those at the front of the pack move on to other strategies.

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Avoiding the Herd Mentality

While it's tempting to follow the newest investment trends, an investor is generally better off steering clear of the herd. Just because everyone is jumping on a certain investment "bandwagon" doesn't necessarily mean the strategy is correct. Therefore, the soundest advice is to always do your homework before following any trend.

Just remember that particular investments favored by the herd can become overvalued because the investment's high values are usually based on optimism and not on the underlying fundamentals.

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