Harnessing The Herd Mentality

Running with the herd feels a lot safer than running against it.

There is a sense of psychological security that comes from doing what others are doing - and when it came to our early human ancestors forming tribes and deciding to flee rather than fight when some imminent and potentially overwhelming danger appeared, it worked well.

But as investors, the urge to run with the crowd can be costly. The performance of sharemarkets around the world in May probably has some investors thinking of hitting the flee button. So it is worth considering what prompts you to buy something and what makes you decide to sell?

Self-awareness is one of the great attributes of successful investors. Warren Buffett cheerfully admits he is not the most technologically savvy investor - can't quite picture him queuing up in Omaha to buy an iPad - and as a result has missed many great investment opportunities with companies like Microsoft and Apple, but he stayed away on the basis he didn't understand their businesses.

While Australian data is not as comprehensive, there is ample evidence from the US mutual fund industry of just how strong the investor herd mentality can be. Looking at net cash flow of US equity mutual funds between 1993 and 2008, there is a strong correlation between stockmarket performance and cash flows.

That is, when markets rose investors clearly got excited by the positive returns and followed the performance with more money - the 2000 tech wreck the clearest example. Conversely when markets were in negative territory in 2002 and 2003, that was when more people were sellers than buyers right before the next market run up began.

So we are reminded endlessly that past performance is no guarantee of future returns. This is true, but what past performance does look like being a reliable indicator of, is future investor buying and selling behavior. In blunt terms - and there is anecdotal market evidence to suggest this is underway today - it means that after a sharp market correction like we have seen in the past month, investors will decide that the risk is too scary and want to avoid the prospect of losing money.

Risk aversion and healthy skepticism of marketing claims are great defence tools for investors. But just as we understand the dangers of irrational exuberance and excessive optimism there are also times when negativity can be overwhelming - when no matter how low prices fall, it seems no amount of potential return can make the risk worth taking. The fear of capital loss is paralysing. We saw that after the Lehmann collapse at the height of global financial crisis in 2008.

The interesting question, as an investor, is to ask yourself - at what point would you be a buyer? The answer - when you look at behavioral finance studies - probably has less to do with potential return projections and more to do with the emotional pendulum swinging back to where investors begin to act on risk of a different kind.

This is the risk of missed opportunity - and certainly with the benefit of hindsight we can all look at things in 2008 and speculate about "if only".

In some ways the most surprising thing about investor sentiment as we emerged from the global financial crisis was how quickly optimism returned - no doubt strong market returns helped - but it was a surprise at how short investor memories seemed to be.

So perhaps the latest bout of geo-political uncertainty and Eurozone debt issues is simply a healthy albeit unsettling reminder that challenges may well lie ahead for several years, and that the optimists looking to consign the GFC to history may have a chapter or two to go before the book can be closed.

The challenge for investors is how to stand to the side of the stampeding herd - regardless of the direction it is heading.

It is where a good professional adviser can do some of their best work because of their emotional detachment and context they can bring to the discussion about risk and potential reward.

*** Written by Robin Bowerman, Head of Retail at Vanguard Investments Australia.**