The Risk of Following the Crowd

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When it comes to making decisions, few of us have the ability to go it alone. More often than not, we seek out others for advice, confirmation and validation. This is not necessarily a bad quality in itself. But as we often find when it comes to investing our money, this type of behavior often works against us.

More and more studies confirm that the price we pay for stock rarely reflects the fundamentals of the individual company's financials. These prices often get distorted by people's emotions.

When presented with an investment idea, too often we ask, "Who else is buying it?" Or, as though bigger has to be better, "How much money does the manager have under management?" And, although past returns are no guarantee of and have little relationship to future performance, the most common question of all is, "What was the fund manager's past performance?"

It's not just the general population that asks these questions. Daniel Kahneman, a Nobel Prize-winner in Economics, notes several examples of investment professionals and statisticians – people paid to think rationally – who have made irrational decisions by allowing emotions to influence their judgment.[1]

An entire field of study on this very subject has emerged and is gaining increasing significance: behavioral finance. It studies the influences emotions have over the marketplace. Kahneman and his colleague, Amos Tversky, are responsible for Prospect Theory,[2] which has become one of the cornerstones of this field. Prospect Theory analyzes the asymmetric value people hold for gains versus losses. The authors suggest people are twice as likely to feel the pain of a loss than they are the opportunity to enjoy the benefit of a gain of similar size. This lends perspective to why most people let their emotions drive their investment behavior and often make irrational decisions about their money. For example, rather than accept the finality of a loss, loss aversion often leads to holding stocks that are down in our portfolio for greater time than we do for winning stocks. This behavior has been documented in several studies,[3,4] one of which tracked the returns of stocks after their sale. After observing more than 10,000 brokerage accounts, Terrance Odean noticed that 12 months after the sale of stocks for a gain, the average returns were twice that of those selling for a loss. Obviously, if they had held those "winners" longer and sold the "losers" sooner, the portfolios would have profited more. This study underscores the negative impact that our fearful, loss-avoidant behavior often has on our portfolios.

Recognition of these human tendencies is the first step toward making conscious decisions to change our behavior. Through recognition, we can begin to formulate a disciplined, more rational strategy to managing our money.

Some things to keep in mind:

1. Formulate a disciplined approach to picking individual investments or selecting money managers and financial advisors.

2. Price matters. If you are picking individual investments, make sure the price is based on the fundamentals of the company you are evaluating. Correspondingly, make sure any money manager you evaluate is disciplined in his or her buy-side analytics.
3. Think for yourself – try to avoid the herd mentality. When it comes to investing, bigger is not necessarily better. Formulate a strategy that makes sense for your individual situation based on your goals and risk tolerance.
4. Have a consistent sell discipline, especially as it relates to your losses. Pick a downside pain threshold, take the loss and don't look back or second-guess yourself.
5. Evaluate managers based on strategy first, consistency second and performance last. If you do this, performance will follow.

[1]Kahneman, D. *Thinking, Fast and Slow.* Farrar, Straus, and Giroux, 2011.
[2]Kahneman, D., & Tversky, A. Prospect Theory: An Analysis of Decision Under Risk. *Econometrica,* 47(2), 1979.
[3]Shefrin, H., and Statman, M. The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence. *The Journal of Finance,* 40(3), 1985.
[4]Odean, T. Are Investors Reluctant to Realize Their Losses? *The Journal of Finance,* 53(5), 1998.

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