The Stan Clark Financial Team's

PERSPECTIVES

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Behavioral finance

Herding, Part 2: How to avoid fear-based herd behaviour

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In the last issue, we began our look at the disturbing phenomenon of *herding* in the stock market. You'll recall that herding occurs when large numbers of investors chase after the same investments at the same time. Or, when they sell their investments in a panic because of bad news, or their anticipation of bad news.

In this issue, I'd like to zero in on fear, one of investors' prime motivators for herding – and what we can do about that fear.

This powerful emotion has caused almost every major stock market crash, including: the Great Crash of October 1929; Black Monday on October 19, 1987 (believe it or not, my first day in this business!); and most recently, the pandemic-related crash in February and March of 2020.

What kinds of fears cause markets to fall, often to levels far below what are justifiable by any measure? It can be almost anything: terrorism, political problems, wars, earthquakes or, of course, pandemics. These can ignite turmoil in the markets without really having a significant effect on overall long-term corporate profits. The problem is, once investors start selling out of fear, their behaviour tends to become self-perpetuating.

What can you do to avoid being hurt by fear-based markets? Behavioral finance research shows the need to be guided by a plan or set of rules that serves your particular short- and long-term financial goals. Above all, it involves sticking to your rules, no matter how panicked you feel.

With stocks, it's easier to stick to the rules if you understand how our free-enterprise economic system works. True, our system is subject to booms and recessions. But companies operating within the system are, as a whole, very good at adjusting to changes and finding ways to make money – profits – over time. And you, as a shareholder, share in those profits, both through dividends and increased share prices from reinvested company profits.

Yet, even knowing all this, your emotions may still overrule your logic. To stick to your rules, it may help to change some of your behaviours.

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For example, you could stop watching business and investing shows, and quit reading the business pages of the daily papers. Or, press the mute button when the nightly newscaster starts talking about the economy. Daily news is laden with emotion and focused on the short term. If you need to feel in touch, read high-quality weekly or monthly publications. You'll feel a lot calmer about your investments and long-term strategy.

It also helps *not* to track your portfolio's value day to day, or even month to month. Yes, you do need to ensure that your portfolio is being managed according to the plan and strategies you set up for it. However, monitoring short-term results will give you little information of true value. Short-term performance is mostly influenced by luck and random noise, and will only cause you to become emotionally involved.

In the end, the best approach is to trust in the plan and strategies you adopted. Realize that they won't work in every period. But, if properly designed with built-in resilience, they will give you the best chance of succeeding over time. ■

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