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CAN PROFESSIONAL MANAGERS BE FOOLED BY 'HERD BEHAVIOUR'?

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In previous articles, I have talked about the *herding* phenomenon: How it not only causes market bubbles and crashes, but also stocks to be over- and undervalued.

This month, let's examine why supposedly savvy fund managers are susceptible to herding behaviour, sometimes even adopting it as a deliberate strategy.

We'll start with the late, brilliant British economist John Maynard Keynes, perhaps best known for advocating government spending to break the downward spiral of an economic depression. What's less known is that Keynes wrote extensively on the psychology of investing – and on the errors both amateur and professional investors make. Keynes's theory on government spending remains controversial. However, no one disputes that he was an astute investor. His insights are well worth learning.

To illustrate investor behaviour, Keynes used the following example: Suppose newspaper readers must choose the six prettiest faces out of 100. To win the contest, you also have to rank the contestants in order of popularity. In other words, you aren't choosing based on your own preferences about beauty. You're guessing the average preferences of all other readers.

Keynes said that similarly, rather than choosing stocks based on the investments' actual worth, investors try to guess what other investors will do. They herd with the crowd to chase after popular stocks. The more focused investors are on short-term results, the more likely they are to use this herding behaviour.

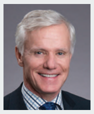
Professional fund managers, whose main customers are institutions such as pension funds or foundations, are especially prone to herding. The institutions keep these fund managers under a constant microscope, comparing them to other money managers, and often with a short-term focus. This punishes anyone who acts differently from the crowd. Keynes warned, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

In *How Markets Fail*, John Cassidy refers to a recent study that confirms Keynes's view: "If an investment manager goes with the crowd and things turn out badly, he gets to share the blame with everybody else; if he follows a contrarian strategy, he bears sole responsibility for his mistakes."

The problem is often magnified because most pension funds are foundations run by board members who are not necessarily investment experts. Keynes wrote that those adopting an approach different from the crowd "will in practice come in for the most criticism whenever investment funds are managed by committees or boards."

The tendency to follow the crowd could be a major reason most mutual funds underperform the market averages. Leading fund managers such as Peter Lynch and Warren Buffett succeed by acting independently; by not investing like everyone else. Early in their careers both Lynch and Buffett experienced one of the major pitfalls of value investing. They bought in too soon, when prices had fallen enough to make an investment seem good value – only to have the market continue to fall because of herd behaviour. But they learned from this, persevered and in the end succeeded.

How to protect yourself from herding? First, be wary of money managers using subjective approaches that can be influenced by herding. Find out if they cater mostly to institutional investors. If they do, their investment philosophy could be too geared to short-term results. Ensure they use a process not to protect themselves from looking foolish – but one with objective criteria for picking stocks likely to outperform.



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