

Are You a Member the Herd?

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The investment lessons I learned from discussing investments with my former associates at Chrysler have stayed with me to this day. Where better to observe investor behavior than in a factory full of highly paid union employees during the 1990's stock market frenzy? I learned very quickly that nearly everyone who had an opinion about investing had the same "great" idea – TECH STOCKS. *I wondered how this idea could be so great if everyone already knew about it.* My instincts were wrong for more than a year. I watched CNBC and the party being thrown – NASDAQ 2,000, 3,000, and 4,000. The talking heads were euphoric. Friends and family were telling me the same thing. I resisted the temptation to join the party even though everyone I knew was growing richer by the day. This lesson, unbeknownst to me at the time, has been extensively written about in the field of behavioral finance. Investors it seems are like lemmings, eager to follow one another over the impending cliff of doom. Behavioral Finance practitioners call it "herd behavior". Let's look at why this phenomenon persists and how to avoid it.

The societal pressure to conform is the driving force behind herd behavior. Most people have a desire to be accepted. Who wants to be the outcast? By following the herd, you are invited to be a member of the group. You instantly have "water cooler" conversation material. The pressure to conform can be extremely difficult to resist. One investor who pays no attention to conformity is Warren Buffett. I remember reading article after article during the Dot-Com boom espousing the Oracle of Omaha's demise. Mr. Buffet did not buy tech stocks, he was of the old order, and to many he was becoming irrelevant. In hindsight, however, Buffet was doing exactly what he has always done. He was applying common sense principles and sticking to his guns. He was investing in what he knew. Today, it seems rather obvious that it was Mr. Buffet who was the rational investor.

The second force that pulls us toward the herd is consensus. How could your friends, colleagues, and the media *ALL* be wrong? It takes discipline to remain focused. Remember that each stock has a limited number of shares. Logic dictates that if everyone already owns shares, who else is going to buy them? It is demand that drives up prices. You need more buyers than sellers. If everyone has already bought, who is going to step up to the plate? At some point the price obtained from selling will become so high that institutional investors will line up in droves to book their profits. And you, the novice, will be left holding the bag.

So how do we ignore our emotions and invest with discipline? The answer is so incredibly simple yet behaviorally so difficult to implement that even professional money managers routinely fail. *The answer is to construct a globally diversified portfolio and rebalance.* You should first select various asset classes and assign target percentages. Next, you must rebalance by formula or by time frame, such as once a year. It must be a *mechanical* process. You will be forced *to sell your winners and buy your losers (buy low, sell high)*. The undisciplined investor does exactly the opposite – he is a reigning member of the herd. Rebalancing forces you to move against the herd. It will put you on the path to investment success. At Pile Wealth Management, we are not a member of the herd.