THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

THE WARMTH OF THE CROWD

Anyone, taken as an individual, is tolerably sensible and reasonable – as a member of a crowd, he at once becomes a blockhead
- Freidrich von Schiller

Imagine you are travelling to a new city. After the whole day of sight-seeing, one of the most important decisions you need to make is which restaurant to dine in. You narrow down to two restaurants located next to each other, which are quite similar in terms of cuisine and menu prices. One of them is empty and the other, crowded, which one would you choose to dine in?

While making decision, most of us love the warmth of the crowd. We trust the wisdom of a large group to choose the right restaurant, movie, music, phone etc. And most of the time, this herd instinct or herding works well for us. Herd instinct is a mentality that is distinguished by a lack of individual decision-making, causing people to think and behave in similar fashion to those around them. Unfortunately, this behavioral bias has some serious consequences in the investing world.

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One of the essential conditions of a well-functioning market is diversity of views. Investors, making unbiased assessments of the securities and acting independently, cause efficient price discovery. This is because even if their individual thinking is faulty, the mistakes would cancel each other out. This diversity is lost when investors follow what they perceive other investors are doing, rather than their own analysis. In other words, an investor exhibiting herd instinct will gravitate toward the same or similar investments based almost solely on the fact that many others are buying the securities. Herd instinct has a history of starting large, unfounded market rallies and sell-offs that are often

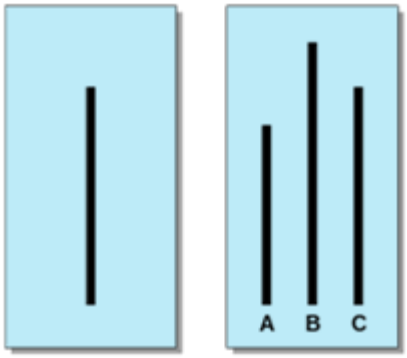
based on a lack of fundamental support to justify either. This has been a significant driver of asset bubbles in financial markets.

In two of my previous notes, I have discussed how fear of missing out and biases like confirmation bias and cognitive dissonance negatively impact investors' buy and sell discipline. In this issue, we look at investors' need to conform to the crowd which causes herding.

SOLOMON ASCH EXPERIMENT

Solomon Asch conducted experiments to understand the degree to which a person's own opinions are influenced by those of groups. In one of the experiments, participants were called in groups of 8 and shown two cards. One card had one straight line which had to be matched with the 3 lines shown in the other cards.

Asch experiments are important in understanding that people feel the need to fit into the group.



Source: Wikipedia

Each participant was supposed to call out the answer in terms of A, B or C. Asch has designed the group in such a way that there was only one test subject in the group, others were confederates who were told to answer in a particular pattern. There were 18 trials and the confederates were asked to answer 12 of them incorrectly.

About 75% of the actual test subjects (excluding confederates) went with the majority at least once and 32% of the test subjects went with the opinion of the majority all the time. Privately, these subjects were able to give the correct answers, but they preferred to conform to the crowd during tests. Asch experiments are important in understanding that people feel the need to fit into the group. In subsequent experiments, Asch was also able to prove that:

- Conformity increases if the group is large

- Conformity increases when subject is faced with higher uncertainty (Difficult task)
- Conformity increases when members of the group are of the higher status

All these observations are extremely important to stock market investing. The crowd is obviously much larger, and the media also contributes to providing a high-pitched broadcast of popular ideas. Intrinsic values of companies are uncertain and don't have a definite mathematical formula. Influence of experts (who are also vulnerable to herding) is also high on individual investor's opinion.

HERDING BEHAVIOR IS ALL PERVASIVE

Subsequent research to the Asch experiments has shown that the influence of crowd is observable everywhere:

People have learned to accept what experts tell them to be right, even if it does not seem so.

- **People tend to believe that the crowd cannot be wrong:** Psychologists Deutsch and Gerard conducted experiments to prove that wrong answers in Asch's experiment had been given mainly because people simply thought that all the other people could not be wrong.
- **People underweight their skepticism to expert opinion:** Stanley Milgram showed the enormous power of authority over human mind. He observed that people have learned to accept what experts tell them to be right, even if it does not seem so.
- **Investors who have poor performance are more likely to follow the crowd:** Maxime Merli and Tristan Roger experiments in the French market revealed an interesting link between past performance and mimetic behavior. It appears that investors who suffer poor performance while going against the herd, are more likely to join the majority in the subsequent period.
- **Even Analysts display herding behavior:** Bret Trueman, in a paper in 1994, showed possible herding behavior among security analysts. Analysts tend to release forecasts similar to those previously announced by other analysts.

- **Professional managers also feel the pressure to herd:** David Scharstein and Jeremy Stein highlight the pressures of reputation risk (and career risk) which force professional investment managers to herd with other managers.

CONTRARIAN THINKING IS DIFFICULT BUT NECESSARY

It is tempting to be part of the crowd and indeed painful to avoid the herd instinct. Contrarian investing (going against the crowd) is more about the emotional strength (Behavioral Edge) than knowledge (Information Edge). Neurologists have found that the parts of the brain that respond to exclusion, were the same parts that responded to physical pain. In other words, the feeling of being excluded or rejected provoked the same sort of reaction in the brain that physical pain might cause. Standing against the crowd is hence extremely painful.

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However, for successful investing, contrarian thinking is important. Swaying with the pendulum of market mood can compel the investor to buy during a bubble and sell during a crash. To take advantage of these market swings, an investor needs to design a good investment philosophy & process and follow the same with discipline to generate superior returns compared to the crowd.

It is equally important to have the right team or right set of people to discuss investment ideas with. In the experiment, Asch found that having one of the confederates give the correct answer while the rest of the confederates gave the incorrect answer, dramatically lowered conformity of the test subject. It shows that most investors can improve their decision making with the right support.

NIMESH CHANDAN
HEAD – INVESTMENTS, EQUITIES
CANARA ROBECO

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).