BEHAVIORAL FINANCE 101 - STICKING WITH THE HERD

Wildebeests on the African Savanna travel in herds, providing them some protection from lions or other predators. If one restaurant's parking lot is nearly full while the lot of the restaurant across the street is nearly empty, you may be correct in thinking that the first restaurant is a better dining choice. If a building's hallways are filled with screaming people rushing towards the exits, you may want to join them – certainly if you were outside you wouldn't plan on entering, would you?

Whether animal or human, we exhibit signs of herd behavior, and that is not necessarily a bad thing – but sometimes it's an awful thing.

We are social animals, and following the opinions and behaviors of the crowd makes us feel safer and also helps avoid conflict. Like wildebeests, if our herd starts moving in one direction, we tend to stick with the herd and follow. Do you take pride in your independent thinking? Do you believe you can resist the siren song of the crowd and walk to your own drummer, impervious to the arrows of noncompliance being hurled at you? Watch this old Candid Camera video athttp://vimeo.com/61349466 to observe the stress endured from simply facing the wrong way in an elevator – and the eventual decision to stick with the herd.

You can observe herd behavior every day in the financial markets. An interesting statistic is the flow of money into and out of mutual funds. Quite often, there is an inverse relationship between money flowing into a particular type of fund and its subsequent performance. For example, at the bottom of the last recession, money poured out of stock funds, just before the stock market generated some of its best ever returns. At the peak of the tech bubble in 1999, individuals following market trends continued to add to bloated technology stocks despite the absence of any fundamental data supporting their decisions.

Warren Buffet has successfully resisted this "bandwagon effect" by continually being greedy when others are fearful and fearful when others are greedy. But consistently being a "contrarian" investor is a difficult thing to do. We find it more palatable to fail conventionally while following the crowd than striving to excel unconventionally.

If you find that you can't resist the crowd, then what should you do?Retain an advisor to help you? More bad news – your advisor is subject to the same herding behavior. Advisors have to deal with their own challenges, including pressure from their clients and their peers. Contrarian strategies often take a long time to work and few clients, or advisors, have the patience and commitment to see them through. This explains why many "value" managers had 20% of their money in overpriced tech stocks at the top of the tech bubble.

Another problem is that many times the crowd may be right – at least for a considerable period of time. Therefore, swimming against the tide results not just in psychological pain, but also hits you in the wallet. The important thing to keep in mind is that while the crowd can be right for a while, it is always at the turning points – at the extremes – that the crowd is precisely and dramatically wrong.

Learning to recognize these turning points and having the courage to act upon your convictions - despite being uncomfortable in doing so – is the challenge for all of us.

In what ways does behavioral finance impact your decisions? We're here to help as you plan for your future.

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