Following the herd can be a dangerous game

JOHN LOOBY
COMMENT

The Nobel committee deciding on the 2002 prize for economics broke with tradition by awarding it to a psychologist: Daniel Kahneman.

The award was primarily for his paper with Amos Tversky in 1974, Judgment Under Uncertainty: Heuristics and Biases. It acknowledged that Kahneman and Tversky had shaken the key assumptions underpinning classical economics.

Their portrayal of human decision-making as being littered with systematic short cuts and biases casts doubt over the key assumption of rationality. It helped to spark new fields of "behavioural" inquiry in economics, finance and elsewhere.

Unfortunately, such inquiry has been confined largely to the margins, with mainstream economics continuing to assume the world is a rational place.

Consider this 1997 quote from Paul Krugman, another winner of the Nobel prize for economics: "If you want a simple model for predicting the unemployment rate in the US over the next few years, here it is: It will be what [Alan] Greenspan [then chairman of the Federal Reserve] wants it to be."

In the wake of the collapse of Lehman Brothers in September 2008, Greenspan underlined his own (now severely shaken) belief in the assumption of rationality when he admitted: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity — myself especially — are in a state of shocked disbelief."

It is a slow process, even for Nobel winners, to convince long-standing believers to question a key assumption underpinning their view of the world. The global financial crisis and the failure of mainstream thinking to provide explanations have, however, intensified the doubts raised by Kahneman and others. A richer understanding of the forces that can cause such a crisis is clearly needed.

In this respect, Kahneman and his work on decision-making and its systematic biases offer much material. Andrew Oswald, an economist at Warwick University, has also provided insights that are of particular relevance to investors.

Taking his lead from the animal kingdom, Oswald argues that herding is the rational response of most individuals in most situations, because human happiness is a function of relative rather than absolute position within a group. He makes a compelling case that humans are frightened of falling behind, and are consequently prompted to adjust their relative position within a group, just as an animal seeking safety will do in a herd. As with the herd, however, individually rational behaviour can lead to collective catastrophe.

Oswald uses a graph of the real price of American housing from 1892 to 2010 to show how such individually rational but herd-like behaviour can lull many into ignoring objective evidence and plunging to collective catastrophe. The equivalent graph for Ireland would look even more dramatic.

Some of the lessons for the investor are clear. Succumbing to the powerful instinct to maintain a relative position in a charging investment herd, however individually rational, is inviting catastrophe.

The striking success of value-investing — only buying assets below a reasonable assessment of their true worth — is more richly understood by reference to Oswald's work on the herding instinct of humans. If you must seek comfort in an investment herd, make sure it is populated by the followers of Warren Buffett, the Sage of Omaha. If you can't resist the herding instinct, at least ensure it works in your favour.

John Looby is an investment manager at Setanta Asset Management, a dedicated value manager based in Dublin

Deflated house price index