Emotions and herd instinct

Keynes said: "*Investing is trying to predict how other investors will behave.*" As far as financial and stock markets are concerned, the herd instinct is the law of the land. Years spent in investor-related affairs have taught me how conventional and repetitive the (not so) average investor's (and IR officer) behavior is, as an individual or in a company. Forget the allegedly "sophisticated" economic models and the growing – and even more worrying – weight of algorithmic trading. At the end of the day – perhaps should we write at the beginning – the so-called rationality of market agents is mainly about human assumptions, decisions, actions, and… emotions. Société Générale's rogue trader Jérôme Kerviel, accused in January 2008 of

"unauthorized" trading for amounts as large as the bank's total market value, said about his behavior: "*You lose your sense of the sums involved when you are in this kind of work. It's disembodied.*" Traders' hormones seem to rule their behavior more than occasionally.[1] Are we still in rational territory? Writing about the financial "*storm*," Vince Cable reminds that John Stuart Mill had already analyzed the "*frenzy of over-trading*" in the 18th and 19th centuries.[2] Daniel Kahneman, a Nobel Prize winner and one of the most famous founders of the behavioral school of economics, notes: "*Emotions constantly inform our judgments.*" Moreover, "*Professional investors fail a basic test of skill, persistent achievement*" and suffer from "*cognitive illusions*" which lead to failures such as the total lack of anticipation of financial crashes.[3]

Why should a Dow Jones, Nasdaq, or any other index's sneeze lead to fever and a cold on other exchanges, and impact on companies' stock (and beyond) which have no direct relation? It is not an investment manager who says: "*Investors should also insulate themselves as much as possible from Wall Street's propaganda machine.*"[4] It is baffling to watch how a craze for a stock can artificially influence the market perception, create bias in company real fundamentals analysis, and result in wrong investment decisions. In July 2000, when the dot-com bubble was deflating, Fortune magazine pointed out that over a recent period "*of the 33,169 buy, sell and hold recommendations made by stock analysts... only 125 were pure sells.*

1 A financial website writes without joking: "*How to profit from hormonal markets*" (www.moneyweek.com, March 16, 2012). While FT columnist Gillian Tett says that "*Regulators must get grip on traders' hormones*" (Financial Times, March 15, 2012).

2 Vince Cable: "*The Storm: The World Economic Crisis and What it Means*" (Atlantic Books, 2009).

3 Daniel Kahneman: "*Thinking, Fast and Slow*" (Farrar, Straus and Giroux, 2011).

4 Edward Chancellor, GMO investment manager, commenting on the work of Daniel Kahneman, in: "*Humans are naturally bad investors,*" in the Financial Times fm supplement ("*The Last Word*", January 9, 2012).

That's 0.3 percent... Just over a third of the ratings... were strong buys..." Eight years and millions of buys later, a New York Times article noted that, among others, Merrill Lynch analysts were finally learning to say "sell".[5] Learning, really? The New York Times wrote this at a time when most financial sector stocks were overpriced and a few weeks or months before their fall in the worst financial crisis since World War II or before. Some shareholders might remember that RBS's share price was 600 pence in April 2007 – and most analysts' tip was to buy more stock. It was still at 500 pence in October 2007, before the planned acquisition, jointly with two other European banks, of the Holland-based ABN Amro (a move then applauded by the ever-rational (buy-side?) financial analysts, and backed by a large majority of – mostly institutional – shareholders). One year later, share price had fallen to 175 pence, before further falling by almost 50 percent in a few weeks. In January 2009, shares had fallen below 15 (fifteen!) pence.[6]

This is another paradox of capitalism: a system that stresses individualism as a main virtue relies heavily on going with the crowd. In a highly perceptive comment on the role of human behavior in financial crises, Shahin Kamadolin, an economist at the Dutch Rabobank asks: "*Are we all herd animals?*" He goes on: "*The history of financial crises shows that the herd can very often head in the wrong direction and we decide to follow them regardless. The reason... is that we regularly suffer from information cascades – we make choices based on the observations of choices made by others... even if our information differs.*"[7] This contradicts the entrepreneurial and innovative behavior, summed up e.g. by Alan Kay: "*Don't worry about what anybody*

5 Fortune magazine, July 24, 2000; The New York Times, May 21, 2008.

6 "*RBS timeline: where it all went wrong*" (Daily Telegraph, December 2, 2010).

7 "*Asset bubbles, financial crises and the role of human behaviour*" by Shahin Kamalodin, Rabobank Economic Research Department (January 2011).

else is going to do... The best way to predict the future is to invent it."[8] Investors and analysts rarely behave that way.