Resisting the Crowd
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The Wall Street Journal ran an interesting article recently (Humans Naturally Follow Crowd Behavior, September 12, 2014) about how humans follow other humans when in a crowd. Some of the examples seemed unremarkable, such as when everyone at a sporting event looks in the same direction. Isn't that the idea of going to a sporting event – to watch the action?

But the reporter described an experiment that really was remarkable. The subjects were shown photos of four other people who were in a crowd looking in the same direction. But the photos were shown of the individuals, not the whole crowd, and each was photographed from a different angle. The photos were shown for less than a quarter second. Even with these constraints, the subjects were able to synthesize the four faces and determine the direction the group was looking.

Other animals are inclined to work in crowds, too. Bluefish and other predatory fish will herd baitfish through their coordinated actions. Another magnificent example is the white pelicans I used to watch on a southern Minnesota lake. Rather than diving into the water like the brown pelican, these birds worked in a group to herd their prey fish while swimming on the lake surface. From a distance, it looked like a water ballet with all of the dancers decked out in white.

We humans, like other creatures, have learned to work in groups, and that has generally served us well. But sometimes following the crowd can be a disadvantage. That is often the case with investing. For example, when a particular stock or even a particular part of the market is in favor, people follow the crowd and keep piling in. The crowd can push prices higher than they might ordinarily go. Eventually the crowd will pull back and prices will settle back down.

Our firm has developed a methodology to avoid the crowd-joining tendency of humans. That process is the rebalancing of client portfolios. Here's a simplified example. Let's say we wish to allocate 50 percent to U.S. stocks and 50 percent to companies outside the U.S. There will be times when investors begin to favor U.S. investments. If the crowd mentality takes hold, more and more cash will flow into these investments, raising the prices. Over time, the client portfolios will be out of balance, with perhaps 65 percent in U.S. stocks and only 35 percent overseas.

We monitor each portfolio balance weekly so that we are aware of the divergence. We will allow that to proceed for a while, but once we have reached our limit of tolerance, we will harvest the profits from the outperformer and buy the underperformer. Sooner or later, the tide will likely switch, and we will be

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rewarded for buying the low-priced assets.

Humans have developed behaviors that help us function in crowds. When it comes to investing, however, sometimes it is better to step away from the crowd and take a more thoughtful approach.

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