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## Your Mind and Your Money-Herd Mentality

Monday, February 15, 2010

TOM HUDSON: We know that human beings are social animals. That means we place a high value on being part of a group. So does that herd mentality also extend to how we invest? In his next report, Dan looks at the evidence.

DAN GRECH: Have you ever noticed how animals tend to move together in groups? Whether it's birds, elephants or cows, they all seem to share the same instincts to herd. The question is: do we as humans share this same herding behavior?

PETERSON: Herding is a response to having not enough information and thinking that others around us can actually give us a shortcut to how to make a decision.

GRECH: Dr. Richard Peterson is a psychiatrist who now manages hedge funds. He says the impulse to stick with the group dates back to our earliest ancestors.

PETERSON: If we're in a group of people in the Serengeti and one person starts running, we probably either want to pay attention to what they're running away from or start running with them, because those who didn't do so would be a meal for the lions.

GRECH: Today, lions are less of a problem, but the desire to be part of a group still runs deep. Safety in numbers is one reason people join investment clubs like the Polaris investment club in Palm Beach Gardens, Florida. Once a month, club members meet to invest the cash they've put in the treasury. Sally Escott helped found the club 15 years ago . She says one strength of the group is that members do not always agree.

SALLY ESCOTT, POLARIS INVESTMENT CLUB: We don't get to the fisticuffs stage. We just debate and if you're on the winning side of the vote, that's fine and if you're not, that's OK. You go do it on your own.

GRECH: That range of independent views has helped the Polaris Club win a national portfolio contest eight years in a row. Co-founder Len Gilman says in other investment clubs, group-think often prevails.

LEN GILMAN, POLARIS INVESTMENT CLUB: Our club does not have anybody who is monopolizing or strong-arming or over influencing others and this has been the downfall of some investment clubs.

GRECH: Studies have found that going against the majority is incredibly hard. People will generally suppress their own opinions instead. Dr. Gregory Berns is a neuro-economist at Emory University. In one of his experiments, volunteers were shown three-dimensional blocks in various configurations. They were asked: are the blocks identical? When the volunteers were alone, they almost always gave the correct answer: the blocks are the same. But when they were put with people coached to give the wrong answer, the volunteers changed their minds. They said the blocks were different. Berns says brain scans revealed why. The desire to please the group was so strong, it actually altered the way the volunteers saw the blocks.

BERNS: There is, as far as our brains go, kind of no reality. The reality is what we construct in our mind. And that's influenced by other people.

GRECH: So, studies of the brain confirm that people are very sensitive to peer pressure, but some people are able to withstand that pressure. They're not afraid to go against the crowd. They're called iconoclasts. Among investors, Warren Buffett is an iconoclast. He often goes against conventional wisdom on Wall Street. Peterson says being an iconoclast may seem risky, but it's often profitable.

PETERSON: In the financial markets of today, if you see a danger, you can probably bet that everybody else has seen that danger, as well. And in fact, it turns out it's probably best to buy at that time when you see the danger. It's very ironic, but financial markets are completely counterintuitive.

GRECH: So herding may be good for cows, but if you're an investor, even a bullish one, it's one form of animal behavior you may want to avoid. Dan Grech, NIGHTLY BUSINESS REPORT, Cherry Grove Farms, New Jersey.

HUDSON: Those findings on herding also suggest our investment decisions may be swayed by hidden psychological factors. So, if that's the case, how can you take control of your decision making and make the right choices? To find out, let's go to two people who use behavioral research findings as a means to improve investment results: Michael Mauboussin, adjunct professor of finance at Columbia business school, author of "Think Twice" and Denise Shull. She's CEO of Re-Think Group and Trader Psyches, where she advises professional traders on neuro-economics and behavioral finance. We're also happy to welcome Robert Frick, senior editor of "Kiplinger's Personal Finance", who's covering "Your Mind and Your Money" for Kiplinger's. Now, first, Michael, you're convinced the way our minds work frequently leads investors to make some pretty bad mistakes, so does it matter how smart we are investing?

MICHAEL MAUBOUSSIN, ADJUNCT PROFESSOR, COLUMBIA BUSINESS SCHOOL, AUTHOR, THINK TWICE: Yeah, how smart you are doesn't matter because we all come with the same mental software. And there is one bias that all of us share, whether your smart or not as smart and that is a tendency to extrapolate. So what we -- if we've seen good results, we think they're going to go on forever. If we've seen something bad, we think it's going to go on forever. And that leads to what I think is the biggest mistake in investing, which is failure to distinguish between fundamentals and expectations. Fundamentals, basically how the company is going to perform in terms of sales and profits and expectations is what's embedded in the stock price. Those are two really different things and you have to look for the disconnects and where the market's mis-pricing expectations. That's the key -- the key task for investors.

HUDSON: Michael, what about kind of ignoring the crowd, ignoring that herd and having the courage and the confidence to say you think maybe the market's wrong.

MAUBOUSSIN: To be a really great investor, you first do need to be a contrarian. So you have to be going against the crowd. But let just me be really clear about this. Being a contrarian for the sake of being a contrarian is not a good idea. In other words, when the movie theater's on fire, run out the door, right? Don't run in the door. But once you identify a situation where you think you can be a contrarian, then there's a second test. The second test is going back to what I mentioned at the outset, measuring the difference between fundamentals and expectations. Because if the crowd takes something to an extreme, either on the bullish side or the bearish side, that should show up in your disconnect between fundamentals and expectations. And that is what allows you to make a good investment.

HUDSON: Denise, what about kind of ignoring the crowd?

DENISE SHULL, CEO, THE RETHINK GROUP & TRADER PSYCHES: Well, if you really think about it, the only question anyone's trying to answer when they make a risk decision is what somebody else is going to pay for this in the future. You just want somebody to buy it from you for more a year from now or five years from now. So, if you actually asked sort of the social - - what we call the social question, like who's going to pay more for this, three years, five years, whatever your time frame is? And why are they going to pay more for it? You're actually working with the way your brain sees markets and actually even is easier to see probabilities, if you think in terms of which group of people might be buying this. Like, how is it that I know more now than they know and who's going to find out what down road so that they'll buy it from me for 25 percent more than I paid for it.

HUDSON: All right, let's bring in Bob Frick of "Kiplinger's Personal Finance."

ROBERT FRICK, SR. EDITOR, KIPLINGER'S PERSONAL FINANCE: Well, one of the problems that we identify in almost all of these biases is how do you move from emotional thinking to logical thinking? So, I mean, my question to both of you really is how do we know when to use what and how do we stop being emotional? How do we start being logical? How do we get ourselves in the right frame of mind to make the proper decisions?

SHULL: Well, I'm going to jump in their, Bob and say that basically if you're emotionally aware, you have a chance of making a more rational decision. And actually, research ironically shows that, that investors who are both the most emotional but aware of what those emotions are can then be aware of what bias they're operating under and then they have a chance of looking at it objectively and being able to see the bigger picture data set that Michael's talking about. But we haven't been taught to use emotional awareness as part of our decision making. It's there, though. We can't really get away from it. I mean, look at confidence versus fear versus greed. They're always there. So our argument is use them as data and understand and then you have actually a chance of being more rational, ironically.

MAUBOUSSIN: If I could just jump in. First of all, I want to echo want Denise said. I think that's absolutely correct. When you're faced with certain types of situations as an investor or any kind of professional, your mind is often going to take you down one path, when a better way to think about that problem is a different way. So, I would also say learning about these kinds of situations and learning where you're likely to wrong, can be very, very helpful. So, again, it's not that you should be non-emotional, or not be aware of your emotions, it's to be tuned into that and sort of recognize when you walk into potential decision- making danger zones.

FRICK: Right. Now it seems to me in working on this series -- and I think my colleagues at NIGHTLY BUSINESS REPORT would agree -- that there's been a tremendous amount of research done identifying these biases, but very little done helping people overcome them. Michael, is that what you found in your research?

MAUBOUSSIN: Yeah, I completely agree with that, and I think that's the sentiment a lot of people have. They read about these things, but they don't know what to do about it. I'll just mention a couple of things very quickly. The first is keeping a decision making journal. When you make an important decision, write down what you decided, what you expect to have happen and, literally, how you feel. How do you feel physically? How do you feel emotionally? And that allows you to audit your decisions. We always look for confirming information. There's also something called hindsight bias. Once something happens, we think that we knew what was going to happen with a higher probability than we actually did. So, a journal can be really helpful there. Another think I'll mention is a checklist. Sometimes checklists can be very, very helpful in proving our outcomes without improving our skill at all.

HUDSON: And we're going to have to stop there. Michael Mauboussin, Denise Shull and Robert Frick, thanks so much for joining us.

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