Investors Should Beware of the Herd Mentality, *The Concord Journal*, September 8, 2011
By David Chwalek

Since my last column, a compromise about the nation's debt ceiling was reached in Washington and most market pundits assumed we'd be in for a calmer stock market. Unfortunately, the markets have been rockier than ever and we're seeing volatility not seen since the depths of the Great Recession a few years ago. It is times like these that often break the will of even the most disciplined investor and lead to serious financial mistakes. I recently read a comment by British Prime Minister David Cameron in which he referred to the rioting in London as a "culture of fear." I think a comparison can easily be made to how many Americans are now feeling about the economy and their investments.

It's understandable to be nervous but dangerous to act out of fear. In the past few days I've spoken to clients who thought they should sell everything and get out of the market because that's what their co-workers are doing. Others have assumed that they should be selling because CNBC talked about widespread selling on Wall Street. This "herd mentality" can be a powerful motivating force, but investors should be careful not to let their emotions get the best of them.

Incidentally, the term "herd mentality" may have its origin in the method by which Native Americans hunted buffalo 12,000 years ago. Rather than attempt to hunt the buffaloes one by one, the hunters would cause a panic among the herd and drive them into a stampede right off a cliff. Despite the fact that the first buffalo ran off a cliff and fell to its death, the rest of the herd followed suit.

While our human brains are more advanced than those of the buffalo, many people still fall victim to the very same type of herd mentality. Fortunately for us, it doesn't lead to literally running off a cliff, but that's essentially what we're doing to our investments.

An ongoing study by Strategic Insight, entitled *The Impact of Rising and Falling Stock Prices on Investor Behavior*, shows the timing of investor inflows and outflows to or from the stock market. The study illustrates that over the past ten years, people invest more money into stocks when the market is high than when it is low. When do most people sell? You guessed it- when stock prices are low. Obviously, this is the exact opposite of what we all believe is the most prudent way to invest- buy low and sell high. I often ask clients, "When is the best time to buy stocks?" With a few rare exceptions, they all reply, "When the market is low." Similarly, they all agree it's best to sell stocks when the market is high. Yet, during periods of extreme market volatility, some of these same people wonder if they should sell their stocks after a significant market correction.

At a recent investment conference I heard an advisor discuss how he used to give a course on the basics of investing. He would typically average between 15 and 30 attendees per class. In 2000, he was astounded when he had over 150 people registered for one of his classes! If you remember, this was the tail end of a long bull market. He remarked that he should have known then that the market was about to tank. When everyone wants to buy stocks, it could be a sign that it's time to get out.

Another interesting study compares the average stock investor's returns over the past 20 years with the returns of the S&P 500 Index over the same time period. (Dalbar uses data from the Investment Company Institute and Standard & Poor's to compare mutual fund investor behavior with appropriate benchmarks. These behaviors are then used to simulate the "average investor." Ending values for hypothetical equity investments are based on average annual returns.) According to Dalbar, equity investors earned about 5% less per year than the market. What does that mean in real dollars? Even with the two major corrections we've experienced in the past decade, $100,000 invested in the index in 1990 turned into over $483,000 by the end of 2009. The average equity investor's $100,000 increased to only $186,667. The study concluded that it wasn't poor investment selections that led to the underperformance but rather the timing of the investors' buys and sells.

So what does this all mean? Well, if you have the ability to accurately predict market trends, then, by all means, buy stocks when they bottom out and sell them when they peak. If you're like most of us, however, and aren't that prescient, then stay invested through thick and thin. Consider adding to positions that are down and selling after a good run, but stay invested. If you've made a solid long-term plan, that plan doesn't need to change with the momentum of the Dow Jones Industrial Average. Let logic and sticking to the basics determine your actions and leave your emotions out of the decision-making process.

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