Market Dynamics

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Performance Management System

Fads and Herding Behaviors on Wall Street

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

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Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com

I have been amazed at the fads that characterize Wall Street. These herd following behaviors seem to be an integral part of behavior by investors. The fact that fads exist in the financial markets is a given, but why?

I can look back at the fads that I have observed from the conglomerate stocks craze of the middle 1960's and the Nifty-Fifty stocks of the early 1970's to the more recent bubble in Internet stocks and in oil stocks and precious metals stocks. It is a source of amazement to me that so many investors can be duped into believing in these fads. It should be emphasized that professional investors are just as prone to participation in these fads as well as the general public.

It seems to work like this. It starts with an unusually positive fundamental performance by a group of stocks. Their rising stock prices demand explanations for the price increase from the media. Since this is news and it sells, the media readily provide explanations for the price rise even if they have to make it up. The media does not deliberately misrepresent the facts but they may have to guess about what is truly going on and why.

A very important trait of human behavior now starts to influence the situation. It is very common for people, when faced with an ambiguous and uncertain situation, to observe what others are dong and to implement the same behaviors. Dr. Robert Cialdini terms this behavior Social Proof in his very important book *Influence.* This is not mysterious at all and is an almost automatic behavior response. If others are doing this, and the media tells me they are, then I will do it as well.

Following Social Proof is an important contributor to fads on Wall Street. Everyone is doing it and it is paying off so I will do it as well. They must know something I don't, so I will follow along. The media becomes an unwitting accomplice in this situation due to their need to provide explanations for why the stock is going up.

It is highly likely that fads will always be a part of Wall Street since it is a function of human behavior. The investor needs to always be on his guard when getting involved in a Wall Street fad. It should be assumed that every hot stock is part of a fad that will end sooner or later.

When the fad starts to fade, the chart of the stock's relative performance will show it. The first line of defense is to chart the relative performance of every stock in the portfolio. The investor needs to be sensitive to a deterioration in the stock's relative performance. These observations are not "rocket science" but the observations need to be continuous to spot the reversal in a timely manner.

It is not wrong to participate in a fad, but it is often very wrong to stay with a stock once the evidence shows that the fad is fading. It appears that many on Wall Street know how to spot the signs of an ending fad and they act accordingly. They don't average down or increase their position, they get out. The bargain hunters can have that stock since it is probably "washed up" anyway!

W. Clay Allen CFA