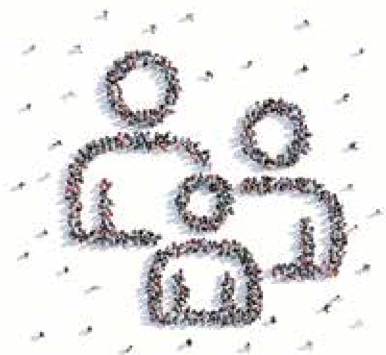


A history of herding

Whether you'd like to believe it or not, the majority of unadvised investors make avoidable mistakes that significantly impact their portfolios. A good financial advisor, however, will help you modify irrational, emotional behaviours that move most investors to make unsound decisions. A good advisor is also like a therapist, someone who can calm you and prevent you from getting in your own way. The value of advice is not always easily understood but it's critical to helping investors achieve their financial goals. Let's turn to a short history lesson to illustrate how humans have the potential to do significant damage to their own financial wellbeing. Not everyone who had an advisor was able to navigate these situations, but we like your chances a lot better if you have a pro in your corner.

Nothing pretty about *this* beauty contest

If you haven't heard about the "Keynesian beauty contest", here's the concept in a nutshell. The legendary British economist John Maynard Keynes observed that investment strategies reminded him of a game once staged by a London newspaper. Readers had to pick out the six prettiest faces from 100 photographs, with the prize being awarded to the reader whose choice most closely corresponded to the average preferences of the competitors as a whole.

Instead of choosing their six favourites, many readers tried to guess whom they believed other readers would select. Clearly, this beauty contest descended into an exercise where efforts were devoted to anticipating what the average opinion expects the average opinion to be. Yeah, we think it sounds ridiculous, too.

What do financial bubbles and beauty contests have in common?

Keynes noticed similarities between reader behaviour and how investors behave in the markets. The decision to buy and sell stocks often involves anticipating how the average investor might value a particular stock. If the price of XYZ stock keeps rising, it must be because other investors think the business will continue to grow, so the crowd piles in without questioning whether the growth is already priced into the current share price. Can you say "FOMO"? (That's "fear of missing out" in case you're not a social media guru.) If everyone ends up being wrong, well, it's much easier to fail conventionally than succeed unconventionally.

Human beings are herd animals. We survive in coordinated groups and align our behaviour with those around us. Many investors seek the perceived safety of the crowd, jumping on the bandwagon when a certain stock or sector is in favour and jumping off when sentiment turns negative. That's how market bubbles grow and burst. Collective greed drives prices higher just as collective fear does the opposite.

So, whether you're judging the attractiveness of contestants or the attractiveness of certain stocks, it's easy to fall prey to blindly following the crowd.

Bubble bubble, toil and trouble

Let's look at some prominent historical examples where irrational investor behaviour moved markets dramatically, creating and erasing huge amounts of wealth in the process.

Tulip mania 1593	A non-fatal virus changed the colour on tulips and this new-found scarcity caused demand to surge. At the peak of the bubble, a tulip was actually worth an estate[i]. At the bottom, a tulip was worth an onion.
South Sea bubble 1720	England was struggling to meet its debt obligations in its war against France. South Sea Company stepped in and proposed to take over 60% of Britain's debt in return for exclusive trading privileges with South America and a 5% interest payment. Following this lucrative trade agreement, other companies joined the bandwagon with new dodgy and misleading schemes to deceive investors. By the late 1720s, none of these schemes materialized and panic selling ensued, causing the market to sink like a stone[ii].
The Roaring 20s	As a massive new consumer class was thriving after innovations like the radio and airplanes. Everyone wanted to get in on the action and so many investors started to buy stocks on margin, often only putting down 10% of their own money and borrowing the rest from their stock broker. Banks used customer deposits to fund risky speculations and fuel this rapid expansion. By late 1929, runs on banks and the explosion of consumer debt led the U.S markets to implode, sparking the Great Depression[iii].
1970s "Nifty fifties"	The Nifty 50s were widely regarded as solid "buy-and-hold" equities. The delusion was that these companies were so good, it didn't matter what you paid for them as their growth would bail you out. The long bear market of the 1970s didn't spare these 50 stocks.

You may think these examples are from a bygone era. Humans must have gotten better and learned from the past. Guess again! This herd mentality is not relegated to the distant past. Let's go through some more examples from the last 30 years or so.

Crash of 1987	Uncertainty from the Cold War, a new chairman of the U.S. Federal Reserve Board and a falling dollar caused investors to panic. The Dow Jones experienced the largest one-day market crash in history[iv].
Oil crisis 1980s	An oil crisis in the Middle East led to fuel shortages and sky-high prices in the wake of the Iranian Revolution. The parents of one of our own EdgePointers buried a barrel of oil in their backyard. Fast forward to the mid-2000s when the barrel was taken out of the ground – the cost for taking it out was more than the actual price of oil for that same barrel!
Japan late 1980s	Japanese government officials were growing uneasy about the skyrocketing value of the Nikkei Index and soaring land valuations caused by low interest rates and increased money supply. In May 1989, the government tightened monetary policy by raising interest rates, causing stock prices to plummet. By 1992, the Index plunged by over 55%[v].
Tech boom of 1990s	Hundreds of "Dot-com" companies appeared out of nowhere and investors pumped huge amounts of capital into these high-flying technology companies. By early 2000, reality sunk in and investors realized that the tech sector was grossly overvalued. The speculative tech bubble burst amid the herd's panic selling.
U.S. housing bubble 2000s	After the tech bubble had burst, many U.S. investors moved to the "safety" of real estate. As housing prices spiked, mortgage fraud, condo flipping and property purchases by sub-prime borrowers portended a market bubble. Sure enough, by 2011 the average U.S. house lost almost a third of its value and the impact on mortgage-backed securities led to a major global economic contraction[vi].
Commodity bubble 2000s	The boom, also known as the "Commodity Supercycle" (1992 to 2013), was largely the result of rising demand from resource-hungry markets like China. However, as China's economy slowed, this decade-old commodity boom crashed in 2015 and sector conditions remain challenging today. The price of oil bottomed in early 2016 falling nearly 75% from its peak set in 2014[vii]. Although slightly recovering, the price of oil in January 2019 is still down roughly 50% from its 2014 highs.

Emerging markets bubble 2000s	Encouraged by meteoric growth in China and India, investors have been eager to uncover the next big emerging market. Sadly, heavy investment in emerging markets amid unrealistic growth expectations overheated many emerging economies and put downward pressure on these fragile markets. For example, Brazil and China are the two largest emerging markets economies. In 2008 both the Brazilian and Chinese markets fell by close to 70% from their 2008 highs[viii]. Over 10 years later both markets still remain over 50% below their original peak in 2008.

And let's not forget the recent drama of cryptocurrencies like Bitcoin or marijuana stocks that have taken speculators on a wild ride of dizzying highs and painful lows.

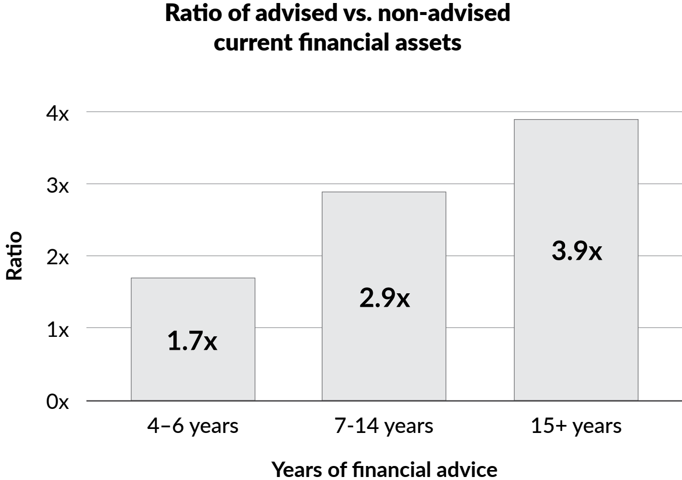
However, despite all the bubbles and busts, the equity market has been the best way to compound wealth overtime. A single $100 investment in the S&P 500 Composite Index in the roaring 20s (1920) would be worth over $1.6 million today on a total return basis[ix]. Time is the chief ingredient behind the magic of compounding. Unfortunately, the sad reality is that most investors would not have captured this return because of their own behaviours.

The value of sound advice

So, what can you do to navigate these treacherous waters? At EdgePoint we strongly support professional financial advice. A decade ago we decided to partner with financial advisors because we believe investors' interests are best served by advisors who have the specialized knowledge and experience to guide you through all market conditions. Digging into the archives, in 2014 we wrote a commentary identifying the key advisor attributes that, in our observation, have generally led advisors to be more successful at helping their clients meet their financial goals.

We went through so many market declines that you may be thinking why would I pay someone if my portfolio is dropping in value? Isn't that making a bad situation even worse? A skilled advisor can help you resist the urge to react emotionally. Your advisor will keep you focused on the long term so you can weather short-term challenges and grow your wealth over time. This doesn't mean a good advisor can prevent your portfolio from declining in value over the short term. However, the patience you exercise during these bubbles and subsequent crashes is what distinguishes a successful investor from an unsuccessful one.

Similarly, maybe you're wondering why you should pay an advisor when your portfolio is making gains. Isn't it better to do it yourself? Good advice also matters in strong markets so you can maintain investment discipline and avoid becoming greedy and venturing into stocks or sectors that everyone is raving about at dinner parties. As you've seen, market bubbles are very real and the consequences when they burst can be devastating.



Source: IFIC, January 2018

Keynes would be proud

Find a good advisor and communicate often and openly. Have a solid long-term investment plan. Stick with that plan through short-term market noise. A smart, sensible approach like that is attractive enough to win any beauty contest!

[i] "A Series on Depression – Tulip Mania of 16th Century Holland" The Economics Journal, November 26, 2008. https://econjournal.wordpress.com/2008/11/26/a-series-on-depression-tulip-mania-of-16th-century-holland/. Accessed on January 19, 2019.

[ii] "South Sea Bubble" library.hbs.com,. https://www.library.hbs.edu/hc/ssb/history.html/. Accessed on January 15, 2019.

[iii] Peter Rappoport and Eugene N. White. "Was There a Bubble in the 1929 Stock Market?" The Journal of Economic History,. Vol. 53, No. 3 (Sep., 1993), pp. 549-574.

[iv] Source: Bloomberg LP. Dow Jones Industrial Average declined 22.6%, or 507.99 points on Oct. 19, 1987

[v] Source: Bloomberg LP. The Nikkei index (Nikkei 225) declined 63.23% in $JPY, from Dec. 29, 1989 to Aug. 18, 1992

[vi] Source: Bloomberg LP. S&P/Case-Shiller U.S. National Home Price Index, a measure of U.S. residential real estate prices, declined 27%, from Jul. 2006 to Dec. 2011

[vii] Source: Bloomberg LP. WTI Crude Oil, a benchmark in oil pricing declined 74.32% from Jun. 14, 2014 to Feb. 10, 2016.

[viii] Source: Bloomberg LP. Brazilian market as measured by the iShares MSCI Brazil ETF. The iShares MSCI Brazil ETF seeks to track the investment results of an index composed of Brazilian equities. The ETF seeks investment results that correspond generally to the price and yield performance of the MSCI Brazil Index. The iShares MSCI Brazil ETF declined 65.32% in $US from May 26, 2008 to Nov 17, 2008.

[ix] "Shiller S&P composite monthly pricing data", R. Shiller, accessed January 1, 2019, http://www.econ.yale.edu/~shiller/data/chapt26.xlsx. From January 1, 1920 to December 31, 2018 a single $100 investment in the S&P 500 index including dividends would grow to $1,603,225.

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