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What is herding?

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Herding behaviour refers to the tendency to follow the majority. In the animal kingdom, goats and sheep travel in herds for safety from predators and help in finding food. Similarly, there is a social tendency for people to herd with others acting in the same way at the same time.

WHY IS IT IMPORTANT

Sometimes, people herd for a rational reason, such as incomplete information or a concern about reputation.

On the other hand, irrational herding due to emotions such as fear and over-optimism should be avoided as it can cause significant information loss, inferior information aggregation, and impaired decision-making.

Investors should always do their own due diligence. Due to uncertainty, investors might choose to follow the experts' opinion because they believe that the experts have better information than themselves.

When investors are afraid of losing their reputation by being different, they may herd, too. For example, professional fund managers may herd by following general market trends, as they did during the dot-com and the 2008 housing market bubble.

The mentality behind that is: "I know that the market is overpriced, but as long as everyone is still buying, I should not exit now as I may lose".

Institutional investors such as mutual funds herd more during the down market than the up market, possibly owing to fund managers' career concerns.

While the leader of the herd earns no superior returns in general, the followers underperform. It is alarming that institutional herding can further distort security prices in a down market.

In a corporate setting, managers are prone to herding if they are concerned about how others will assess their ability to make sound judgments.

Group psychology may discourage junior managers from voicing their real independent assessments. To have a more effective and productive discussion, juniors should be given a chance to voice their opinions before seniors in a safe environment where they will not be unduly judged or coerced.

More generally, a bottom-up organisation of information flow is better than a top-down one.

How can investors take advantage of irrational herding behaviour?

Investor Warren Buffett thinks herd mentality can be leveraged. He once said: "Be fearful when others are greedy and greedy when others are fearful."

Thus, there is a contrarian or counter-trend herd in markets too, although it is much smaller.

More importantly, investors should always invest based on fundamentals and valuations instead of blindly following others.

Lastly, herding can improve investment decisions sometimes. Researchers find that in a multi-stage decision setting, herding on the initial decision can actually result in superior decisions.

That is, when faced with complex decisions, the team leader who perceives the danger of herding will have more incentive to provide higher-quality information to outweigh the information loss of herding.

Such earlier herding helps to reduce the length of the decision-making process.

Examples include entering new markets, funding of research and development and early-stage venture capital.

IF YOU WANT TO USE IT, JUST SAY

"Herding behaviour is where people act in the same way or adopt similar behaviours as the people around them. There are dangers and benefits of herding behaviour. It pays to remember to 'be fearful when others are greedy and greedy when others are fearful'."

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