INVESTORS GONE WILD!

Heard Mentality: What is it and how to overcome it.

"If everyone jumped off of a bridge, would you do it?" If you ever heard that expression from your parents, or if you are just now purchasing a pair of skinny jeans and a fidget spinner for your kids, you can relate to "herd mentality." Herd mentality describes the tendency of people to conform to a group by adopting certain behaviors. Herd mentality can be harmless when it comes to buying Beanie Babies, eating kale, or posting selfies on Facebook. However, it can be an especially harmful behavior when investing.

What is Herd Mentality?

Behavioral finance combines psychology with economic and financial theory to study the different psychological biases that humans possess when making investment decisions. One of the biases often studied is herd mentality. Herd mentality causes people to gravitate to the same type of investment based on the fact that others are acting in the same way. People feel more comfortable relying on the wisdom of the crowd and tend to invest their money in the same way as the majority.

There is plenty of evidence that shows how investors chase returns. They wait to see what has done well and when the evidence is clear, they buy, usually when the price is high. When the investment fails to perform, they hang on too long and sell low. This is the exact opposite of what an investor should do. Take, for example, the cover of Barron's March 9, 2009 issue. The herd mentality was indicating that it was *not* the time to purchase stocks, when in fact, it was the bottom of the market... to the day!

BARRON'S

SPECIAL RETIREMENT REPORT
10 Stocks For the Next 10 Years
Page 23

The Dow Jones Business and Financial Weekly www.barrons.com March 9, 2009 $5.00

ALAN ABELSON • 3
Mr. Obama rubs his crystal ball

MICHAEL SANTOLI • 9
Home Depot versus Lowe's

EVIL TWINS? • 20
What separates BofA from Citi

REFOCUSED • 22
Bristol-Myers finds the right medicine

UNFAIRLY BASHED • 29
The truth about Northrop Grumman

A WEALTH OF IDEAS • 31
Hey, Apple, do this with your cash!

DRUG MONEY • 34
A whistle-blower takes on Wachovia

SPLAT!

Herd Mentality: Bubbles and Crashes

Driven by investor emotions such as fear and greed, investors can, in a frenzy, begin to purchase or sell stocks creating bubbles and crashes. In fact, psychologists Milgram, Birkman, and Berkowitz conducted a study in the Journal of Personal and Social Psychology in 1969 (the results have subsequently been confirmed) showing that our propensity to conform and follow the crowd increases with the size of the crowd. At the height of a bubble or craze, things tend to make sense because it is what everyone else is doing. It is only when something falls out of favor that people wonder what they were thinking.

> "The one who follows the crowd will usually get no further than the crowd. The one who walks alone, is likely to find himself in places no one has ever been." - *Albert Einstein*

Just recall two of the more infamous bubbles in history: The Tech Bubble of 1999 and the Housing Bubble in 2007. These bubbles started as a buzz, then escalated as prices spiked without regard to the intrinsic value of the underlying assets. It was difficult to resist the "once in a lifetime" opportunity as the net worth of colleagues, friend, and neighbors skyrocketed. Greed was overriding fear without much concern over the inherent risks in their investments.

How to Avoid Herd Mentality

It takes strong emotional discipline not to chase after the latest fad, whether it is the latest hot stock, hot sector, or hot investment strategy. So how can an investor overcome herd mentality?

Successful investing needs an ***unemotional and disciplined process*** to provide ***long-term steady growth***. When using the services of an active manager, look for the following:

-Consistency in their process. A manager's process should have rules designed to remove emotion from the buying and selling process.

-High Active Share. Active share compares the holdings of a manager with the holdings of its benchmark index. Some active managers, for fear of poor returns, do what others are doing and merely follow an index (termed closet benchmarking). The higher the active share, the more a manager is actively working to outperform their benchmarks (and not follow the herd).

-Low Turnover. Managers who tend to hold their stocks for the long-term (3-5 years or more) are considered to have low turnover in their portfolios. Studies have shown that managers with both high active share and patient investment strategies (low turnover) tend to beat their benchmarks. [1]

Conclusion

It is hard not to follow the crowd when the media provides daily reminders of how well-off people are from following trends. However, a consistent, disciplined process focusing on steady long-term growth is what will help you stay away from "falling off the cliff" of investing when the next big trend falls out of favor.

Endnotes

[1] Konigsberg, Ruth, "New Study Identifies the Most Underappreciated Investment Skill," http://time.com/money/3652118/new-study-identifies-the-most-underappreciated-investment-skill, (January 5, 2015).

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