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Finding wisdom in unexpected places

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“Definition of a crowd: A number of persons congregated or collected into a close body without order”

“Crowds are somewhat like the sphinx of ancient fable: It is necessary to arrive at a solution of the problems offered by their psychology or to resign ourselves to being devoured by them.”

- Gustave Le Bon

Generally, we do not hold the opinion of crowds in high esteem. Or, we like to think that, as individuals, we have better knowledge about any specific topic than the crowd. Therefore, we are not really inclined to trust the opinion of the crowd. What we, however, fail to recognise is that embodied in the crowd's opinions are the specific viewpoints of experts – which on their own could be quite off the mark – while other members of the crowd with all sorts of diverse opinions tend to moderate the experts' views, but collectively often provide surprisingly better answers!

Charles Mackay's classical *Extraordinary Popular Delusions and the Madness of Crowds*, first published in 1841, portrayed the well-known stories of irrational investor behaviour, such as the Dutch tulip mania in the 1600s and the trade in South Sea Company shares in the 1700s. Mackay concluded: "Men think in herds. It will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

Invariably, usually sane people lost their shirts in the follies that surrounded these episodes. Sir Isaac Newton, the brilliant scientist, lost a fortune during the South Sea bubble and famously remarked: "I can calculate the motion of heavenly bodies, but not the madness of people."

1634-38: Tulips



- The earliest well-documented financial bubble was for a bell-shaped flower. Some Dutch families mortgaged their life savings for these bulbs, some of which could cost as much as a home.

Source: CNN Money

1720: South Sea Co.



- It was called a sure thing by British bankers who successfully hawked South Sea's shares as a play on New World trade. But profits never materialized, investors bailed, and South Seas' officials went to jail.

Source: CNN Money

For an overview of financial asset bubbles and bursts over the past five centuries, follow the link below:

http://www.indexinvestor.co.za/index_files/MyFiles/Five%20Centuries%20of%20Bubbles%20and%20Bursts.ppt

In more recent times we have witnessed price bubbles in Japanese assets, IT stocks, and lately the real estate market that was fumed predominantly by western world credit frenzy and lethal credit derivatives. Currently, we may be experiencing another gold rush and perhaps watch out too for Chinese asset prices that is following some familiar paths to the Japanese experience in the 1980s. Clearly, how could one ascertain that the collective opinion is by any means smart at all, at least not with the body of evidence that the history of financial markets presented thus far?

Yet, James Surowiecki, author of *The Wisdom of Crowds* (published in 2004), explained in his bestseller why the crowd's opinion often may be more trustworthy and accurate than those of individuals, however difficult to acknowledge, especially if one is in the presence of experts or happens to be an expert oneself!

Surowiecki identified three main types of decision-making where the crowd's opinions often excel, namely:

- Cognition

Typically, thinking about and the processing of vast amount of information. For example, in market judgment situations where the crowd can act much faster, more reliable and perhaps less subject to the influences and forces that often shape the deliberations of experts or committees.

- Coordination

For example, how people optimise their collective behaviour in traffic jams, busy pathways or popular restaurants. It is unlikely that any individual in the group would come up with an optimal and speedy solution to these tricky spatial problems, yet collectively we do find solutions without constantly bumping and colliding into each other.

- Cooperation

How groups of people with supposedly self-interest objectives can willingly form networks of trust without a central planning system controlling their behaviour or enforcing compliance. For example, who is planning the daily supply of bread and milk to the inhabitants of a major modern city? Imagine how difficult it would have been for people brought up in former communist countries to understand how the free market system could allocate resources efficiently and effectively without any explicit central planning!

But of course, Mother Nature provides us with fantastic examples of how groups work effectively together, seemingly without order or explicit command-and-control systems in place. The studies of social insect colonies like ants and bees reveal invaluable clues. For example, foraging ants leave the nest in search of food and at first each ant disperses randomly. The ants that find food come back to the nest and leave a chemical trail for others to follow. Thereby the shortest path to food sources is consistently identified. But of course a particular food source will become exhausted over time and therefore some foraging ants will leave the well-trodden ant trail in search of alternative food supplies. Thereby the constant supply of food to the colony is ensured, and thus their survival. [An analogy perhaps is to

think of the need of businesses to constantly identify viable alternative practices, products and services to maintain a competitive edge in the business environment]

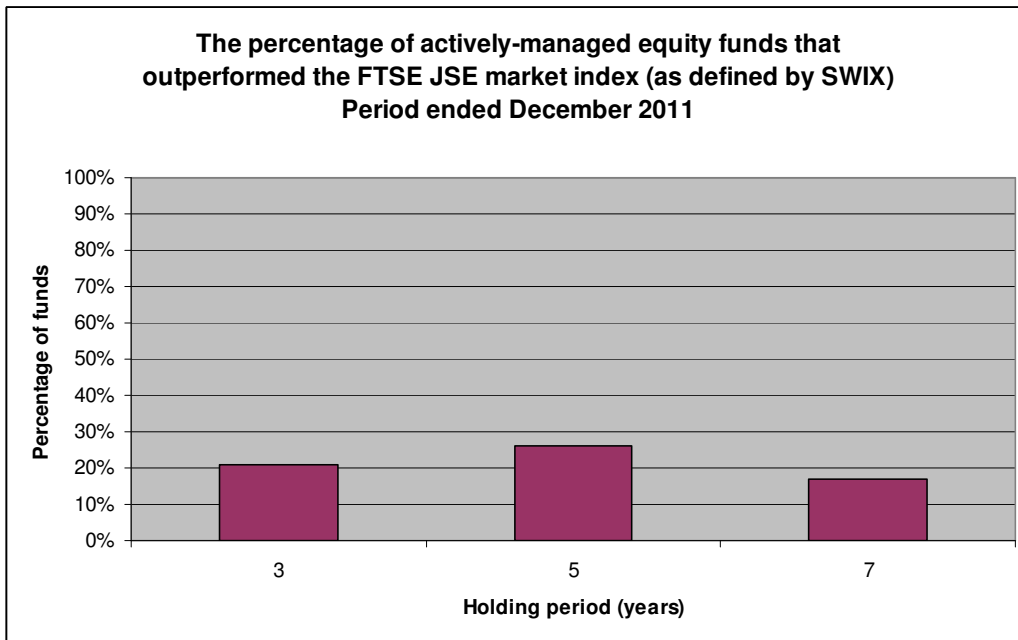
Honey bees on the other hand are executing a particular “dance” to communicate with other bees when food sources are found. In fact, scientists are of the opinion that the “dance” routine conveys also vital information about the type and quantity of food. What do we learn from the study of insect colonies?

We have to recognize that these insects collectively are solving very complex problems which one would not have expected given the limited and modest attributes of the individual insects. Thus, the whole is far superior to the simple sum of the individuals. Yet, as humans we tend to resort to command-and-control systems or we rely heavily on expert opinions in various fields. Basically we ignore the potential value and power of collective intelligence. Moreover, we could perhaps extend the “safety in numbers” to a “intelligence in numbers” concept!

To be sure, experts are absolutely necessary in our daily lives, especially where problems are predominantly rules-based and technically demanding. For example, if you need a plumber to fix leaking water pipes, you will call a plumber and not dozens of your friends and acquaintances to convene, form a committee, debating your problem and finally issue a media release how the problem will be resolved (you would have been lucky if this process also involved someone actually capable of doing the necessary repairs!).

Some systems, however, are very complex, dynamic and not necessarily rules-based. For example, consider the stock market. We often may find that the value of experts is perhaps overvalued relative to the market’s views (which incidentally is available at relatively low cost and little effort) at any given point in time. Alternatively, we cling to the views of experts why prices of stocks may be incorrectly priced as if the market’s opinion is always wrong or that the market is collectively stupid in assessing the true value of assets.

In fact, to appreciate just how difficult it is to prove the market wrong, consider the number of professionally-managed equity funds that outperformed the equity market index over reasonable periods of time. The graph below illustrates the relatively low percentage of actively-managed equity funds (managed by professional investors) that outperformed the FTSE JSE Shareholder Weighted Index (a typical performance benchmark) over recent years. Clearly, it is not even a 50/50 distribution and it seems that the odds are heavily stacked against professional managers to beat the market.



Source: DRW Investment Research

Yet, we also need to recognise that stock markets are for some very good reasons not as effective as bee hives or ant nests to unlock group intelligence all the time. The stock market differs in two fundamental ways from the hives and nests of social insects. Firstly, incentives differ materially. For the insects it is all about the well-being of the colony, whereas investors place their self-interest first. Secondly, the insects use specific routines to communicate with each other, whereas the price mechanism in markets conveys certain information to investors in allocating their resources effectively. But prices also do much more than conveying information, it actually influences investors to imitate behaviour and therefore may lead to gross inefficiencies (price bubbles) from time to time.

Thus, it is possible that stock markets may well be very intelligent at times, but at other times are subject to excesses. Surowiecki identified a number of conditions that are necessary for groups to act intelligently:

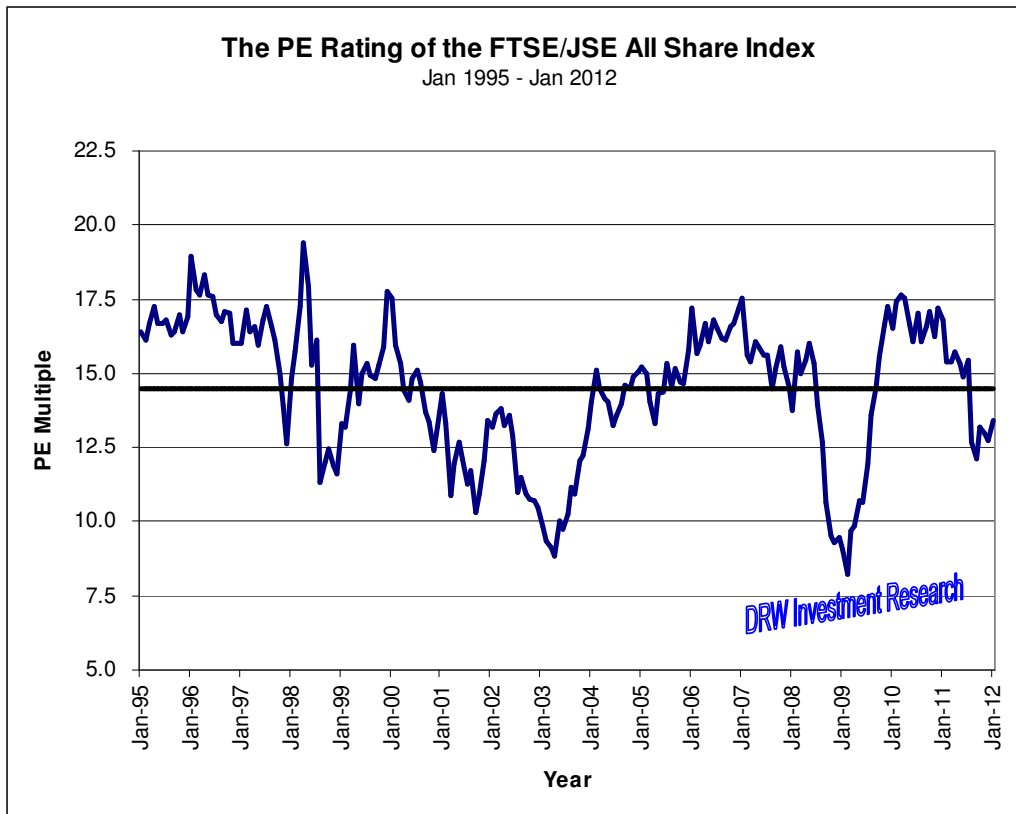
Firstly, diversity of opinion is crucial to formulate well-calibrated group answers as members will bring different pieces of information to the table. Each member of the group should have some information even if it is only a limited interpretation of known facts. In other words, wild guessing without applying some thought will not lead to intelligent groups. Moreover, if decisions are biased in the same direction it is not likely to result in good group decisions. Not surprisingly, the best collective decisions are the product of disagreement and rigorous debate.

Secondly, independence and decentralisation of opinions are paramount in formulating intelligent group answers. This is obviously a difficult feat because our opinions are influenced by the people around us. For example, committees may easily turn out to be too homogeneous or committee members' opinions may be easily swayed by dominant leaders within the committee. Thus we may make decisions what we think other people are likely to think or which will be popular. [One commentator remarked in the wake of the 2008 financial crisis that boardrooms perhaps are filled with too many left brain dominated people and not enough right brain dominated people to ensure sufficient diversity of opinions! Apparently there is quite a difference between how left brain and right brain dominated people will approach decision-making processes].

Thirdly, an incentive (reward) and mechanism must exist how to collate and aggregate the opinions of people into a collective verdict, like polls, prediction (betting) markets and stock markets. Typically we find that the collective does very well in prediction markets in so far as getting the odds right who are the likely winners of a match, competition, tournament, and etcetera.

From our earlier discussion about stock markets we know it is not easy to beat the market. However, we realise the market's opinion oscillates between extreme pessimism to extreme optimism over time. While pessimistic market ratings represent normally not a bad time to invest for longer-term investors - in fact it is probably the best of times - the real danger of destroying investors' wealth is specifically during those times when market spirits are running high and investors are prepared to throw caution to the wind. Typically, investors then are buying assets without a clear or proper understanding of the fundamentals. To be sure, it is extremely difficult not to get excited about investment prospects and at the same time we fear the regret of missing out on quick moneymaking opportunities. But the era of over-optimism will end and those investors that bought assets towards the end of the cycle will learn some dear lessons.

The bottom line is how do we gauge whether the market's assessment of asset prices is fair or not? A simple metric to use may be the price earnings (PE) multiple of stocks plus a casual survey of financial headlines. The graph below depicts the PE multiple of the FTSE JSE All Share Index since 1995 and clearly we find ourselves currently in somewhat below-average market ratings relative to the historical average.



Moreover, if you hear conflicting views about what is going to happen next - thus there is no broad consensus among commentators and investors what to expect - chances are the market (collective) is doing an excellent job of pricing assets fairly. To my mind that is exactly where we find ourselves with market ratings today!

Sources:

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