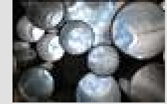
ABFG April 2011 Newsletter



This Month

Our article this month is from Cynthia Harrington about herding behavior in the financial services industry. We also have information about two upcoming CFA Los Angeles behavior finance related events. One is by Richard Peterson of the ABFG about using social media to predict market behavior. The other is sponsored by another CFALA community of interest about market booms and busts.

Managing Our Ingrained 'Schooling' Bias by Cynthia Harrington, CFA, CFE

Today's investors often 'school' together, massing into investments because the momentum and numbers are there. While schooling has its evolutionary advantages, it can also breed a dangerous complacency and conformity. Manage this behavioral bias with some tips on how to swim with the crowd, yet peel away when conditions warrant.

Herding bias shows up in the markets when groups of players act ensemble. Or we might think of it as behaving like schools of fish. Grouping together and darting here and there, together, aids survival. Food found by one can be shared by many. Predators have to chase the group rather than the one, making evasion easier.

While "herding" is the classic term for investors who behave similarly based on their observations of each other, the analogy to schools of fish seems a little more apt in today's world of computerized market movements. Herding is a good term, but more applicable to the solid footfalls of past market animals than the speedy sub-penny moves of today's algorithmic market participants. So, let's talk about schooling—sort of "herding as fish would do it"—as an updated metaphor for the behavior of today's market participants.

We can apply the findings of behavioral finance to both manage the risk of schooling in the markets as well as to profit from the behavior of other investors. I'll share some statistics with you about how to identify when schooling is happening in the markets. Then I'll show you some new tools that can help you identify and keep away from those fish that are getting a little too close to the whale's mouth.

Newsletter

This is a monthly newsletter from the Applied Behavioral Finance Group (ABFG), An Associated Group of the CFA Society of Los Angeles, CA.

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Mission

To identify, evaluate, and disseminate information and activities in the field of behavioral finance. Our objective is to enhance collaboration between research and practitioners in order to produce practical applications of value for investors and professionals who serve them.

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Herding and homebodies

Although the markets are now more prone to schooling, the research we use to understand these behaviors is still all grounded in the old term, herding. Behavioral researchers have perhaps studied the bias of herding for longer and in greater depth than many of the other behavioral biases. That, and the fact that it's an easily observable behavior, makes it a worthwhile one to investigate.

As with all behavioral biases, this one has an important evolutionary function. Imagine what life would be like if we didn't herd. We wouldn't form families, communities, or political parties. Coming together around similar interests creates support systems that are critical to sustain life. In this way, herding is essential to survival.

Clearly, we do not want to get rid of all of our activities that result from our desire to form groups with like-minded people. But it would be nice to nimbly navigate around these behaviors in the markets. Following the crowd at the right time to find food and evade predators, then splitting off to go one's own way just in time, would be an ideal investment strategy, wouldn't it?

So what does this bias look like? Behavioral finance researchers focus on analysts' earnings recommendations to give us one method of identifying schools swimming together. For years, according to one study, the earnings forecasts of analysts at sell-side firms would move together like preteen girls at the mall. From the period 1987 to 2004, researchers at Capital Fund Management in Paris concluded "that financial analysts are on average over-optimistic and show a pronounced herding behavior." Pronounced, indeed. In fact, analysts agreed with each other as to direction of earnings five to ten times more than with the actual result.

Extreme examples of investors swimming together occurs in every bubble. The exuberance in dotcom stocks in the late 1990s is a recent example. As stock prices rose, more and more signs of schooling appeared. The one that flipped my switch was the publication of the book *Zero Gravity*, explaining that dotcom companies finally broke the regression to the mean and we were in a new realm of valuations that did not need to relate to underlying fundamentals. For others, it was the 4,000% increase in the price of Qualcomm. Still, investors who didn't swim with the school into these stocks left profits on the table, while those who stayed too long with the school found themselves whale food.

Thankfully for us analysts, it's the hedgies' schooling behaviors that catches headlines today. *The Wall Street Journal* reports that at any one time, 79% of randomly selected hedge fund returns move in concert, all swimming in safe proximity to others. Quant manager and professor, Andrew W. Lo at MIT, studied funds from 2006 to 2010 and found increasing hedge fund performance similarities, up from

67% in the 2001 to 2005 period.

And it's not just overall performance that shows the chummy behaviors. According to the same article, many of the funds also own the same exact stock positions. At one point in 2010, for instance, 25% of the largest funds all held shares in the bright shiny Apple.

How to swim with the fishes

Moving with the crowd can be profitable in the short run. Buying dotcom stocks, residential real estate, and Apple in 2010 put more than pennies in investors' pockets. It's presumably why hedge managers attend those "idea dinners" and flood into stocks held by compatriots. Presumably this is smart money, and following smart money should lead to hefty and relatively secure profits.

But for those not frequenting the dinners where purchase, and as importantly, sales ideas are being discussed, how is it possible to take advantage of the movements? Is it possible to find the Goldilocks spot, where it's just long enough but not too long at the party? Or is the safer strategy to avoid it altogether and always run the other way?

The answer becomes a choice of style. Here are some strategies and tools to assist you, whichever path you choose.

The first step is to identify when a simple group is large enough so that its behaviors constitute schooling, and the second step is to define your own behavior in relation to the group. The first is relatively easy. The second is made easier by new tools that increase transparency. The task is to investigate and track what market players are doing, and what percentage of the whole system each player commands.

Modeling schools

We can copy the work done by researchers and their agent-based models (ABM) as a way to benefit from this bias. To make an ABM, modelers first identify participants that share certain characteristics, and who are "autonomous decision-making entities" or "agents." One application identifies four groups of specific agents: market makers, fundamental (or value) investors, technical traders (or chartists), and liquidity demanders (or noise traders). The model works by first programming in expected characteristic behaviors of each group and then running a simulation under a prescribed set of economic conditions.

This technique of identifying groups of agents and their expected behaviors based on constraints and beliefs can be adapted to reveal when schools of market participants might be getting too large for the pool.

Consider a couple of examples in which a single group of agents, sharing beliefs and behaviors, affects the market as a whole. Until the 1990s, institutions like pensions and mutual funds held over 50% of

the shares in public stocks. Most followed some version of modern portfolio theory, performed some sort of fundamental or technical analysis, and expected to store the assets long term. The decisions were deliberate, and the outcomes fell along a pre-set group of asset class mandates. Contrast that with the trading volume of the latter 2000s, when near 70% of the volume in the public markets was generated by the crawling algorithms of high frequency traders. The belief sets of high frequency traders led to split-second trades, odd market structures that caused the "flash crash," and extreme volatility in one sector after another.

The decisions and goals of the two groups are dramatically different. The resulting behaviors skewed market moves and threw most strategies that worked in previous decades out the window. Savvy investors who were watching for the size of schools would have been able to adjust their investing strategies accordingly.

A glass-bottom boat

Identifying the agents, quantifying their impact on the market as a whole, and understanding how they think and act is critical. Statistics on the percentage of ownership or activity in public markets are readily available from the exchanges. Several companies provide access to size and strategies of asset managers.

Another resource gives deep access about the behaviors of one group of agents—sort of like a glass-bottom boat that looks beneath the surface at the schools. Position-level data is now available on hedge funds through different service providers. Tools like AlphaClone and FM Analytics can show where some investors are herding into strategies and into certain stocks.

FM Analytics gets daily updates from Security and Exchange Commission registrations, revealing actual hedge fund positions. AlphaClone provides the same, in addition to offering several set portfolio strategies that clone what the hedges are doing. While the information on each fund is no more frequent than the required quarterly filings with the SEC, this service can give a peek into what for so long had been a closed black box.

Once you know the players and their proportions, then you can identify who you are swimming with and for how long you wish to travel with them. With 25% of hedge funds in Apple stock, on top of the concentration in exchange-traded funds, will you know when to pull the trigger? Taking a good look at what you own, who else owns it, and in what amounts gives you basic information for managing the bias. The degree of impact of the other agents can be measured. As both grow, the risks of swimming along grow.

Swimming in the other direction

Tracking the agents and their proportional impact is an important exercise for both identifying and for managing the herding bias. As

the amounts grow, the decision to go should become easier. Leaving the group, however, means emotionally separating from the crowd; sometimes it's a separation from supposed security and safety, and sometimes from the exuberant feeling that the party is where it's happening. Monitoring the size of the school you're running with can help you decide when to go.

Unfortunately, the timing of your leave taking is still a matter of art, but the science of your approach can be fortified by tracking the real numbers of grouped investor behaviors. And it's an important metric to follow, because as the school grows, it looks like an easier dinner to the whale.
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Cynthia Harrington, CFA, CFE, runs a coaching and consulting for professional investors, specializing in applying behavioral finance to investment decision making. She is the author of over 400 articles and co-author of two investment text books. To learn more about Cynthia's services, visit her website at:

Cynthia Harrington

Websites/Links of Interest

You can watch videos from the just completed Milken Institute Annual Global Conference about Behavioral Fnance and many other topics at:

Milken Institute

Upcoming Events

May 18th, 12:00pm at the Omni in Downtown Los Angeles, a look at booms and busts:

Boombustology: Spotting Financial Bubbles

June 21st, Richard Peterson of the Applied Behavioral Finance Group will do a presentation on Predicting Market Prices with Sentiment Analysis of Social Media. Location and time to be determined shortly.

Editor's Invitation

Please write with any ideas, articles, rants, raves about our newsletter etc. to: editor@abfgla.com

We also invite you to view our website, www.ABFGLA.com , and share your thoughts and ideas.