Follow the Investing Herd at Your Peril

Popularity has its pitfalls, Colin Bloodworth explains

In financial planning and business in general, we can be our own worst enemies. We are too often driven by emotion and the fear of being "left behind." This applies to many different fields. Let's look at some of them.

Stock markets

Investing in stock markets should be for the long term. Buying when there is a boom and then selling in panic when prices fall is a recipe for disaster. Yet this is what many people do. When everyone was buying into technology stocks in the late '90s, Warren Buffet, one of the world's shrewdest investors and still one of the richest men in the world, was investing in unexciting things like paint. When the markets crashed in March 2000 his investments held up. He knew it was best not to follow the herd.

No one wants to be left out of a success story. Similarly, no one wants to be associated with failure. The result is that people tend to buy when the popularity of a product or asset drives prices up and sell when they fall. Throughout the history of mutual funds, sales have been lowest when markets are down and highest when markets are booming. But to make money, investors should do the opposite. The problem is we instinctively follow the herd.

A more recent example was the public offering of Facebook shares. When the shares were launched on May 18, they were priced at $38. Now they stand at just about half that figure. Investors rushed in on reports that the stock could rise 50 percent within days. Instead, those who haven't jumped ship have lost 50 percent. What is interesting is how the herd was running in one direction up to the IPO and how it quickly turned tail and rushed the other way at the first hint that things were not going according to plan.

One way to remove the human element is to invest gradually and regularly through all market conditions via a regular savings plan. You then benefit from "cost averaging," which means that you buy more units or shares when prices are low and fewer when they are high. Over the long term, this strategy pays dividends — provided you sell only when prices are higher than they were during most of the time the plan has been running.

Property

Owning a property is likely to be on everyone's wish list. If you find a property you like and it is affordable, nothing should deter you. But if you are tempted to speculate because it appears there is a "gold rush" in a segment of the market, you could end up in tears.

The worst example in recent years was the rush to buy homes in the United States thanks to the availability of easy financing. The loans were based on an assumption that prices would continue to rise. As we all know, they didn't. Instead home values went into a free fall that sparked the banking crisis and financial meltdown of 2008. Those who came off worst were the tens of thousands of homeowners who were forced out of their properties. The banks lost heavily too, but they were rewarded with generous bailouts so they could make the same mistakes again!

Going into business

Anyone who has spent years working as an employee will dream from time to time of "being free" and owning his or her own business. But as anyone who has made the transition will testify, it is not always smooth sailing. In selecting a business, it is tempting to look at successful existing businesses and hope to enjoy equal success by joining those already in the sector. Chances are that others will enter too for the same reason, and by the time they are all set up, there are too many in the field.

Even big business makes the same mistakes. If you have been to Bali recently, you cannot have failed to notice the huge number of hotels springing up. New three-star hotels are offering rooms at less than $30 a night. Great for consumers, but are they going to be commercially viable for the investors? Time will tell, but my guess is that the oversupply will hurt the industry. We see the same happening with airlines.

To be a successful entrepreneur, you need vision and an ability to innovate rather than follow.

So which way should you go?

The best answer perhaps is to keep an eye on the front of the herd. Its early moves may indicate good opportunities, but when the movement becomes a stampede, keep away. It usually ends at the bottom of a cliff. Ignore the herd and stick to your own carefully planned strategy.

Colin Bloodworth, director of PPI Indonesia, has spent over 20 years in Indonesia. If you have questions on this or a related subject, contact the writer at indonesia@ppi-advisory.com.