...and we all follow the Herd Mentality....

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Executive Summary: Following the actions of a larger group without applying the mind is known as Herd Mentality. Although this can happen in any setting, Herd Mentality has increasingly been witnessed when people make financial decisions relating to investments. Herd Mentality is followed to conform to societal pressures and also because of lack of knowledge. It is best to avoid Herd Mentality and stick to investment principles while making financial decisions.

“If everyone is thinking alike, then somebody isn’t thinking” said George S. Patton Jr. The term ‘Herd Mentality’ is probably quite familiar with most of you as it is one of the most common behavioural finance aspects today. Although this does not apply only to a financial situation and can be applicable in any other setting, Herd Mentality has become more and more relatable to financial decisions. This is because of the increasing instances of such behaviour in financial markets in recent times.

Meaning: For the uninitiated, Herd Mentality refers to the tendency for someone to blindly follow and imitate actions of a larger group or taken by other individuals. These actions may be rational or irrational and can be attributable to any situation - both financial and non-financial. The simplest example can be when you sell a stock you hold because everyone else is selling and when you buy a stock because everyone is buying, without understanding the fundamentals. Herd Mentality characterises that you may not be taking the same action if left to yourself. However, you follow the actions of the ‘herd’ whether or not these actions are right and you are said to follow Herd Mentality.

Examples: Now that the meaning of Herd Mentality is clear, let us examine some examples. Remember the case of the dotcom bubble of 2000 or the sub prime crisis of 2008? Or the various scams which hit the Indian stock market? While the underlying issue for market crashes may have been serious and grave, a critical determinant of how stock prices moved during these phases was the Herd Mentality exhibited by investors. For example, in the late 1990s, investors across the world bought internet related stocks and boosted valuation of such stocks although the fundamentals were not strong. This eventually led to the dotcom bubble. Similarly, when investors imagine that holding on to a stock or mutual fund which other investors are selling may not be the wisest of financial decisions; they also end up selling it. Therefore, even if the stock or mutual fund scheme may have strong fundamentals, the price would take a beating because of such irrational decisions due to the Herd Mentality.

Another example is buying and selling precious metals like gold and silver. If you realise that everyone is selling gold, you may want to reduce your exposure even if there is a good future potential for the investment. Yet another example is the purchase of a life insurance policy. If
everyone you know is opting to buy a life insurance by LIC, you may also end up doing so, although you may know that a policy from another insurer has better features and is cheaper.

**Why Herd Mentality:** Herd Mentality is directly related to the psychology of the individual exhibiting the behaviour. An important reason for exhibiting Herd Mentality is because of the need to conform to social pressures. In the case of the life insurance policy purchase, you may feel you will necessarily have to show your friends and family that you also hold a LIC policy. Another reason is because you think the ‘herd’ is more aware or has more knowledge about a particular action. This leads you to behave in the way the ‘herd’ behaves, although you may know that this is not necessarily right for you.

**Should you and can you avoid Herd Mentality?** Herd Mentality is not a good behaviour to follow while taking financial decisions and can result in outcomes which are not to the best of your interests. It is therefore best to avoid Herd Mentality, especially if you are in unfamiliar territory. You may wonder what is wrong in following the actions of experienced investors. Herd Mentality is usually characteristic of following a trend or movement which is popular. When you as an individual investor follow the herd, it usually occurs with a lag. This means most other investors in the herd have already taken advantage of the movement, if any. For example, if there is a new company whose stock price has been continuously rising because of more and more buys, it means a lot of upside has already happened. You may enter the stock at a point when there is not much upside left. This will ultimately result in a loss or at best trim your gains.

Avoiding Herd Mentality is therefore recommended for an average retail investor. Dealing with money aspects based on psychology or behavioural traits can do more harm than good in the long run. While following the herd is an easy option, being a contrarian is also not everyone’s cup of tea. It is therefore better not to adopt extreme actions and stick to investment fundamentals while taking a financial decision. Remember that each person’s money matters are unique and therefore you cannot achieve what you want by just following the herd.

*While the above post is original, concepts have been reviewed from Investopedia.com and other websites.*