So That's Why Investors Can't Think for Themselves

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From February through May, the Dow Jones Industrial Average gained more than 1000 points in an almost uninterrupted daily march upward. Then came the "flash crash" of May 6 and day after day of losses through May. Now, in mid-June, the market has been up six of the past seven days.

Christophe Vorlet

What accounts for these sudden moves? Why do investors so often seem to resemble a school of fish, all changing direction together?

Sometimes the most interesting answers to financial questions come from scientific labs. A study published last week in the journal Current Biology found that the value you place on something is likely to go up when other people tell you it is worth more than you thought, and down when others say it is worth less. More strikingly, if your evaluation agrees with what others tell you, then a part of your brain that specializes in processing rewards kicks into high gear.

In other words, investors often go along with the crowd because—at the most basic biological level—conformity feels good. Moving in herds doesn't just give investors a sense of "safety in numbers." It also gives them pleasure.

That may help explain why market sentiment can change so swiftly, why true contrarians are so hard to find and why investors care so much about the "consensus view" on Wall Street.

In the experiment, researchers from University College London and Aarhus University in Denmark asked 28 people to submit a list of songs they wanted to buy online and then to decide which they would most like to own. Then the participants viewed the ratings of the same songs by two professional music experts. Meanwhile, a magnetic resonance imaging machine recorded the patterns

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of activity in their brains. Finally, as a way to measure the influence of the experts' views, the participants had the chance to change their minds about which songs they wanted the most.

The brain scans showed that as soon as people learned they had chosen the same song as the experts, cells in the ventral striatum—a reward center wired with dopamine neurons that respond to pleasures like sugar and sex—fired intensely. "If someone agrees with your choice, it's intrinsically rewarding in the same way food or money is rewarding," says one of the experimenters, Chris Frith of University College London.

Why might other people's estimates of what something is worth lead you to change your own? Their appraisal could make you unsure that yours is correct. You might become more popular once you agree with others, or joining the experts may make you feel like one yourself. "We are very social creatures," says Prof. Frith, "and we are desperately keen to be part of the group." "When someone influences you, it happens very quickly, in under a second," says the lead researcher, Daniel Campbell-Meiklejohn of Aarhus University. "That mechanism can travel quite quickly through a population."

The experiment also showed that learning that the experts agree with one another—regardless of whether you agree with them—triggers activity in the insula, a brain region associated with pain and heightened body awareness. This suggests that the agreement of others may have a special ability to grab our mental attention. No wonder a consensus opinion is almost impossible for many investors to ignore.

Benjamin Graham, the founder of value investing, wrote that "the market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities." Rather, he added, "the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion." Herding, Graham understood, is part of the human condition.

Thus, if you buy individual stocks, you should note which way the herd is moving—and go the other way. You should get interested in a stock when its price gets trampled flat by investors stampeding out of it. The list of new 52-week lows is a rough guide to what the voting machine has been trashing lately. Then run your own weighing machine, studying the company's financial statements, products and competitors to determine the value of its business—while ignoring the current price of its stock. And make a permanent record that thoroughly details your rationale for making the investment. That way, you set in stone exactly where you stood before the herd began trying to sweep you away. (Source: WSJ-06/21/10)

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