FinancialQuotient

What is herding?

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Herding behaviour refers to the tendency to follow the majority, in the animal kingdom, geese are known to follow leaders in order to avoid predators and help in finding food. In the corporate world, it is a social tendency for people to herd with others acting in the same way at the same time.

WHY IS IT IMPORTANT

Sometimes, people herd for a rational reason, such as economical information or a concern about reputation. On the other hand, irrational herding due to emotions such as herding can cause significant information loss, inferior information aggregation, and misproduction-making.

Investors should always do their own due diligence. For those who have a limited understanding of the market, they may choose to follow the experts’ opinions because they believe that the experts have better information than themselves. When investors are afraid of losing their reputation by being wrong, they will herd instead. For example, professional fund managers may herd by following general market trends, as they did during the dot-com and the 2008 housing market bubble.

The mentality behind it is: “I have a good job, I don’t want to get fired, but at the same time I’m not making much money, so, I should just exit now as they lose.”

Institutional investors such as mutual funds herd more during the down market than the up market, as this helps to protect the manager’s career concerns.

While the leader of the herd earns no superior return (generally, the followers underestimate investment returns), irrational herding can further distort security prices in the market.

In a corporate setting, managers are prone to herding if they are concerned about how others will assess their ability to manage effectively.

Group psychology may discourage junior managers from voicing their independent assessments. Teachers show effective and productive interaction, judges should be given a chance to relax and share their experience in a safe environment where they will not be solely judged for correct.

More generally, a bottom-up organisation or information flow is better than a top-down one.

In the case of irrational herding behaviour?

Investor Warren Buffett classifies herd mentality can be leveraged. “There are times when others are greedily and foolishly buying stocks, a time when others are fearful and foolishly selling stocks.”

Then, there is a contraction or counter-trend herd in markets too, although it is much smaller.

More importantly, investors should always invest based on fundamentals and instinct instead of herd mentality.

Lastly, herding can improve investment decisions, sometimes. Researchers find that in a multi-stage decision setting, herding on the initial decision can actually improve investment decisions. For example, in a simple decision, the team leader who perceives the danger of herding will have more incentive to provide higher quality information and to maintain her leadership. Such leader-follower help to reduce the length of the decision-making process.

Examples include entering new markets, funding of new projects, and early-stage venture capital.

IF YOU WANT TO

Use it. Just say

“Herding behaviour is where people act in the same way as those around them. There are dangers and benefits of herding behaviour. It pays to remember to ‘be fearful when others are greedy and greedy when others are fearful’.”

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