FT.com
FINANCIAL TIMES
Wealth

Let the herd stampede first before making your move

Whitney Tilson
Published: April 12, 2008
www.ft.com/cms/s/0/7020002c-0820-11dd-a922-0000779fd2ac.html

Without doubt, timely and democratic access to financial and market information contributes to smoothly functioning financial markets. But it's worth asking whether the ubiquity of such information today is a friend or foe of sound investment decision-making. For all but the most active professional traders, the answer is often "no".

The biggest problem, as studies have shown, is that investors tend to over-react to news, so its 24/7 availability harms their long-term success.

In a Harvard study by psychologist Paul Andreassen, two groups of investors were given information necessary to value a stock and then asked to trade it. The only difference was that one group received frequent news about every development at the company, whereas the other received only quarterly earnings releases. The result? The latter group traded far less and ended up with twice the profits of those fed frequent news.

Behavioural-finance researchers attribute this tendency to over-reaction partly to what they call "information cascades". For example, a relatively small number of people who respond to bad news by selling can cause prices to fall, which reinforces the apparent wisdom of the early sellers and leads still others to follow the herd and sell. As this activity is breathlessly reported in the media, stock prices can often move much further than the actual changes in investment fundamentals would warrant.

Irrational responses to the latest information can affect buyers even more than sellers. A study by professors Brad Barber (UC Davis) and Terrance Odean (UC Berkeley) found that individual investors disproportionately buy "attention-grabbing" stocks, which they defined as those heavily in the news, those experiencing high, abnormal trading volume or those having just had extreme one-day returns. The authors argued that investors behave this way because of the difficulty in winnowing out good investment ideas – focusing on companies making the news helps limit the choices. But it doesn't help returns: in the study, investors most influenced by attention-grabbers saw their stocks, on average, under-perform.

No one would suggest completely ignoring news about your investments. Enron investors, for example, would have been well served to sell once early reports of accounting irregularities surfaced. But the key is to keep news in context, and act only if further reflection or study indicates that the core thesis for an investment has changed. An earnings disappointment because of a supplier's manufacturing delay – a fixable issue – may say something very different than a shortfall caused by pricing pressure from new competition. In almost all cases, though, letting the herd over-react first before taking action yourself is likely the best bet.

A good example of investors behaving in a manic fashion is in the financial sector. Most days there is news of companies reporting dramatic losses, which drive down stocks, or of companies raising capital or seemingly aided by government intervention, which cause stock prices to soar.

The latest news is that Congress is contemplating large-scale action to alleviate the mortgage crisis underlying much of the financial sector's woes. In addition, several companies have raised money or announced their intention to do so, including UBS, Ambac, Lehman Brothers and Washington Mutual. Given investors' euphoric reaction to all this, one might think that the majority of the write-offs have been taken, that we've seen the bottom and things will steadily improve from here.

Count me a sceptic. The debt bubble that occurred this decade was not limited to subprime mortgages in the US – rather, it was a debt bubble of many thousands of billion dollars that cut across many countries and asset classes, including LBOs, credit-default swaps, commercial real estate, student loans and credit card debt. UBS's own analyst thinks that total losses from the aftermath will eventually be as much as $1,000bn. With total financial company writedowns worldwide at a bit over $200bn to date, we may only be 20 per cent of the way there.

Thus, we don't think the latest writedowns from UBS and Deutsche Bank are the end of this ugly process, but rather the beginning of the next huge wave of writedowns that financial companies are going to take when they report first-quarter earnings over the next month. After a dismal fourth quarter, credit spreads widened last quarter and delinquencies and defaults (not just from homeowners) accelerated.

Our bearishness, however, is not a recommendation to short a general basket of financial stocks. The easy money doing that has long since been made. Funds I co-manage remain short MBIA, Ambac, Washington Mutual, Lehman Brothers and PMI Group, among others, believing that each faces substantial loan writedowns in excess of what the market is expecting. When the herd sees this news, we most definitely don't want to be in the way.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress. E-mail: feedback@tilsonfunds.com