September 2016

Education

Behavioural finance: The power of social proof

September 2015

Herding is in evidence all around us: in business, in the consumer world and particularly in investing. But why does herding happen? And why do herds often form on the basis of such little information? Why do herds form even when that information or such behaviour may be mistaken? The answers to these questions can be found in something called social proof.

Social proof is when people follow the actions of others in an attempt to reflect the “correct” behaviour for a given situation. This urge to conform to established patterns or to follow the lead of perceived authority figures, trendsetters or simply people “in the know” is the social glue that binds people into a herd. Social proof is the underlying psychological bias that results in what we recognise as “groupthink” (or “risky-shift”) behaviour.

In many aspects of life, this tendency to conform and follow is beneficial. In fact, social proof is one of the key human traits that underpinned our evolutionary move to community-based civilisation. The impulse to act like others in the tribe would have been powerful for millennia.

It follows that the operation of social proof is cumulative and carries a reflexive, self-reinforcing momentum. As the effect ripples out across a larger number of people, the size of the herd will multiply, encouraging more people to confirm the assumption that this must be the right way to act.

The best-known experiment that showed the concept of social proof was carried out in 1935 by Muzafer Sherif. He put people into a darkroom and showed them a dot of light several feet away. In reality the dot was not moving but, due to the autokinetic effect, it appeared to move to individuals by different degrees.

When asked individually and then in groups how much it moved, individuals deferred to the group estimate even when it was out of line with their experience. Given the movement of the light was ambiguous, Sherif showed that the participants were relying on each other to define a group-informed “reality”.

The evidence suggests that the social proof bias is amplified in complex situations where the “right way” to act is ambiguous yet the importance of being accurate is critical. In the midst of this complexity, the assumption made is that surrounding people possess more knowledge about the situation. Investing, then, offers perfect conditions for social proof to operate in an exaggerated way, giving rise to the herd behaviour that can drive bubbles and bursts.

Herded investors

When stock markets are falling, there is a strong pull on our emotions as social proof (and loss aversion) encourages an urge to sell if we see others doing so. Why are others selling? Do they know something we don’t? The evidence from behavioural finance suggests the answers to these questions could be surprisingly irrational – that people sell because others are selling.

In stock markets, it is clear that herd reactions don’t need rational thought for fuel.

In the long run, stock prices tend to reflect the intrinsic value of companies. In the short-term, however, the market is often a barometer of changing investor sentiment and a reflection of the average view of the players in the market at that moment. And who would aspire to follow the average investor?

We know from stock-market holdings data that investors are prone to short-termism – stock-holding periods have fallen significantly since 1985. The evidence suggests that some investors – the Chinese in particular – are more short term than others. We know that stock-market participation has broadened significantly in China in recent years as many individuals have opened trading accounts. While institutions still own most of the market, data suggests these small investors can account for as much as 80% of daily trading on the domestic Chinese exchanges.

This raises the possibility that falls in the Chinese stock markets, triggered by short-termist investors, can trigger sympathetic falls in other markets via social proof and herding. In today's synchronised world, it seems like only the first domino need falter to set off a sentimental chain reaction.

Another interesting dynamic to consider is whether there may be large forced sellers in the market. These may or may not be "trend-setters" worth following, yet their large influence on the market could nevertheless trigger trend-following behaviour.

The sovereign wealth funds of large exporters and oil-producing countries, for example, have accumulated large holdings of stocks in recent years. If an oil-producing nation were to sell stocks held in these funds to raise cash due to the hit a lower oil price is having on the government's fiscal position, and that is instrumental in setting off a decline in stock markets, should investors around the world become nervous? Possibly, but then again perhaps these are investors who are exposed to companies who benefit from a lower oil price?

Certainly, it seems like social proof can trigger and exaggerate herd behaviour in the absence of rational drivers. Fortunately, there are natural limits to directional herd behaviour as trends fizzle out and sellers become exhausted. At some point, when the gloom is felt to be overdone, a new trendsetter often emerges – the value-driven investor – who may kick off a new herd behaviour that acts in the opposite direction to encourage a rally in stocks.

With all these mini trends and trend-reversals, the job of keeping up with them is nigh-on impossible – the trading costs would also be onerous. It is little wonder then that successful investors all agree on one thing – the benefit of taking a longer-term view.