Straying from the herd

Quarterly Letter

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Foreword

Where to start after a year like 2020? Given the devastating impact COVID-19 has had on so many families and lives, we wouldn't blame anyone for writing 2020 off as a year they'd like to forget.

But there are perhaps some reasons to be optimistic as we look back over the last 12 months and toward the year ahead. Difficult times often bring out the best in people, and last year was no exception.

The dedication, hard work and tenacity of frontline workers throughout the pandemic has been an inspiration to us all. The public showed incredible community spirit and adaptability, even as their day-to-day lives were continually upended. The arrival of vaccines that could bring us together again after months of lockdowns is a cause for cautious celebration.

None of us could have predicted the year we would have at the start of 2020. Had we known what was in store, we'd all have done things differently. But I hope you feel your Rothschild & Co team have exceeded expectations, working tirelessly to maintain our 'normal' high standards of service and communication.

Overall, our portfolios performed well last year, with our diversifying assets helping us to protect portfolios in the downturn and enabling us to add to our positions at attractive prices.

Making calm, objective investment decisions is never easy, particularly during times of uncertainty. It's tempting to follow the herd when faced with tough choices, but in this *Quarterly Letter*, we explain why fighting those instincts is important. How our ability to stray from the herd, when necessary, is key to preserving your wealth.

Thank you for your continued support and confidence in us. Wishing you and your families a happy and healthy 2021.

Helen Watson
CEO, Rothschild & Co Wealth Management UK

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive.

Rothschild & Co Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000
rothschildandco.com

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Straying from the herd

While following the herd is one of our most natural instincts, we explore how this mentality can be counterproductive in an investment environment

Every year in January, over a million wildebeest prepare for calving season on the plains of the Serengeti. After a couple of months, the adults and their new offspring embark on the Great Migration, chasing greener pastures along a 300-mile loop from northern Tanzania, through Kenya, and back again.

It's one of nature's most breath-taking spectacles. But the journey is fraught with danger. Some of the world's fiercest predators stalk the savannahs of Africa and while wildebeest are fast, big cats are often faster.

Even the best of us get swept up by the crowd sometimes. But to quote General George S Patton: "If everyone is thinking alike, then somebody isn't thinking."

There is safety in numbers, however. The herd provides protection, shielding the weak and preventing opportunistic predators from picking off stragglers. Wildebeest instinctively know not to stray from the herd when danger is afoot.

Sadly, this herding behaviour can be their downfall. After predators, one of the leading causes of death on the Great Migration is drowning.[1] Wildebeest get anxious and hesitant when crossing bodies of water, with perilous bottlenecks forming on the riverbank.

Then, once a few finally get the courage to take the plunge, the whole herd follows. If the river is too deep, the current too strong or the opposite bank too steep, hundreds of wildebeest can drown at once.

Investors obviously don't encounter the same life-or-death situations as wildebeest. If they take a long-haul trip, their biggest enemy is jet lag. And there are certainly no crocodiles lurking by the water cooler!

Yet, despite the comparatively sedate surroundings, they often exhibit the same innate herding behaviour as animals. People seek the safety and comfort of the herd. A popular theory is that while civilisation has developed a lot since our early ancestors lived on the African savannahs, our brains are still playing catchup, evolutionarily speaking.

Unfortunately, following the herd can also be counterproductive in an investment environment. Market booms encourage investors to pile into already overvalued stocks, creating fragile equity bubbles. The predatory threat of a bear market can induce panic selling of fundamentally sound investments en-masse.

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We hope our clients value our thinking. So, in this *Quarterly Letter* we'd like to explain why we're not afraid to stray from the herd, even if it sometimes goes against our natural human instincts.

Emotions versus logic

Do you follow your heart or your head when making decisions?

In the *Little Book of Behavioural Investing*, James Montier explains there are two regions of the brain that help us process information and make decisions: the X-system and the C-system.

The X-system is where information is processed first. Like a fast-food restaurant, it offers a quick, no-frills service and can handle a lot of queries at once. This part of the brain is largely instinctive and heavily influenced by emotion.

The C-system relies on logic and deductive reasoning to arrive at answers. You have to actively engage the C-system; it's not an automatic process, so it's slower, but your responses are less impulsive, more evidence-based.

What does this have to do with herding? There is still much debate over what causes herd-like behaviour in humans, but research shows a big part of the herding response is instinctive rather than logical.

It's hardwired into our DNA to conform with the crowd.

[1] 'Annual mass drownings of the Serengeti wildebeest migration influence nutrient cycling and storage in the Mara River', Amanda L. Subalusky, Christopher L. Dutton, Emma J. Rosi, and David M. Post, June 2017

Follow the leader

Researchers at Leeds University conducted a series of experiments where groups of people were told to walk randomly around a large hall. A few were secretly given details on exactly where to walk.

Participants were not allowed to interact, and yet most people naturally began following the 'informed' participants in a self-organising, snake-like structure. It was similar to how sheep (and wildebeest) herd.

In times of uncertainty, we seem to reach a subconscious consensus in groups: follow the ones who know (or look like they know) what they're doing. The study revealed just 5% of a crowd need to go in a particular direction and the remaining 95% will follow.[2]

A growing body of research shows herd mentality typically leads to bad decisions.[3] However, there are limits to what can go wrong walking around a hall, so let's look at what happens when herding is taken to the extreme in a market scenario.

Bursting your bubble

Tulips are all the rage in the Netherlands. They are the de-facto national flower, which is an impressive feat in a country where approximately a third of all the world's plant and flower trade passes through.[4] The Netherlands exports up to 2 billion tulips every year.[5]

Today, a pack of 10 tulip bulbs will likely cost you less than €10 in the Netherlands. But in the winter of 1637, a single bulb of a highly prized type of tulip reportedly fetched 5,200 guilders, more than enough to buy a lavish canal-side property on Amsterdam's most prestigious street.

To put this in perspective, Dutch painter Rembrandt was paid just 1,600 guilders in 1642 for his enormous masterpiece, The Night Watch.

The Netherlands was firmly in the grip of Tulipmania. Why? Many tulip bulbs had started being sold under legal agreements similar to futures contracts. Growers would commit to selling the bulbs, which were still in the ground, to buyers at a set price on a certain date in the future.

As the popularity of tulips soared, buyers quickly realised they could sell their contracts on to a third party for a healthy profit before the bulbs were cultivated. Word spread and soon everyone was dabbling in tulip speculation, from nobles and merchants to farmers, labourers and chimney sweeps.

People saw their neighbours getting rich and sold their homes and land to invest in flowers.

This herding behaviour allegedly caused the world's first known asset bubble. And like most bubbles, it eventually burst. Tulip prices tumbled, greed turned to fear, and speculators began panic selling. When the herd changed direction, many failed to recoup their original investments and were financially ruined.

As James Montier aptly puts it: 'Crowded exits don't end well. Inevitably, some are crushed in the stampede.'

Like the wildebeest at the riverbank, ill-fated tulip investors had rushed headlong into uncharted waters and been pulled under by volatile currents.

Fear and greed

Much of what we know about Tulipmania was first popularised in author Charles McKay's 1841 classic *Extraordinary Popular Delusions and the Madness of Crowds*. Some economists have since argued the mania has been overhyped, claiming there is not enough evidence that a tulip bubble really occurred.

So, an apocryphal tale? Perhaps. But the tulip craze has enough in common with more recent bubbles to sound credible. In the dot-com boom, it was tech stocks rather than tulips that were the cause of market mania. Overvalued railway shares also led to a bubble in Britain in the 1840s.

Many boom-and-bust cycles are remarkably similar and herd behaviour is often a key factor.

In other words, many boom-and-bust cycles are remarkably similar and herd behaviour is often a key factor.

Exuberance causes investors to ignore the true value of an asset and buy it at an inflated price because they're confident there will always be someone who will take it off their hands for an even higher price. This is the Greater Fool theory.

'Until, of course, the music stops, and the greater fool turns out to be you,' wrote the *Financial Times*' Tony Jackson.[6]

Financial markets and products have evolved significantly since the 1600s; however, investors appear to have been much slower to adapt.

[2] *'Sheep in Human Clothing: Scientists Reveal Our Flock Mentality', Leeds University, 2008*

[3] *'Herd Mentality: Are we programmed to make bad decisions', Exeter University, 2014*

[4] *'Dutch flower industry continues to wither amid coronavirus', Reuters, March 2020*

[5] *'Dutch tulip production set to top two billion blooms this year', DutchNews.nl, January 2017*

[6] *'The Herd Instinct', Financial Times, June 2006*

CNN Business even has a Fear & Greed Index to gauge investor sentiment and provide an early warning sign of when markets are at risk of overheating. Periods of extreme fear and greed can lead to herd-like behaviour, which is then self-perpetuating.

California's Gold Rush, the run on banks during the Global Financial Crisis, and Japan's real estate bubble of the late 1980s and early 1990s are all examples of when greed or fear spread unchecked through large populations.

But while emotions and instinct may contribute to herding, they don't tell the whole story. McKay talks about the 'madness of crowds' in a way that suggests investors act without thinking during a speculative bubble.

In some ways, he's right of course. Selling everything you own to invest in flowers, no matter how popular, can hardly be described as sensible behaviour. There are other forces at play here though, and herding behaviour isn't always as irrational as it first appears.

It would be easy to assume that professional investors and other financial experts would be less prone to this behaviour because of their superior market knowledge and experience. That's not always the case.

Rational herding

Imagine you're going out for dinner and you have a choice between two places to eat, Restaurant A and Restaurant B. They're next door to each other and you haven't eaten at either before. However, you've read a glowing review about Restaurant B, so you intend to go there.

But wait. There is a crowd outside, and the restaurants are only allowing one person in at a time. You are third in the queue, and both people ahead of you choose Restaurant A. Do they know something you don't? Restaurant A *does* seem much busier. What if the review you read was outdated? Or biased?

You change your mind and head to Restaurant A instead. The person behind you in the queue also chooses Restaurant A, having now seen three people go there, and so on and so forth. No wonder it's so busy! The choice becomes easier and easier for subsequent diners because Restaurant A is thriving, while poor Restaurant B looks deserted.

This is an example of an information cascade. It's a type of rational herding behaviour where individuals base their decisions on the previous actions of others.

We have adapted the restaurant example from behavioural economist Michelle Baddeley's book *Copycats and Contrarians*, but the concept was originally proposed by Nobel Prize-winning economist Abhijit Banerjee as part of a model on herding.[7]

In an information cascade, people make a decision based on a mix of personal knowledge (a restaurant review or a friend's recommendation) and social information (one restaurant is busier and other people are going there). Crucially, the individual making the choice doesn't know what other people's personal knowledge is or whether it's high quality. They may be better informed, or not.

An information cascade may start off rationally and quickly become irrational as more and more people ignore their own private information to copy the choices of those around them. If there is a flaw in thinking at the source, this error can be extrapolated and magnified throughout the group.

It would be easy to assume that professional investors and other financial experts would be less prone to this behaviour because of their superior market knowledge and experience. That's not always the case.

Some professional investors knowingly follow the herd even when it goes against traditional investment principles. An example might be buying stocks that are widely acknowledged as overvalued at the height of a boom.

Studies have shown investors may do this because of 'reputational' herding due to career risk. Put simply, they fear for their jobs. In a world where performance appraisals and bonuses are regularly assessed on an annual basis, it's not difficult to see why some investors may be hesitant to stick their head above the parapet.

Herd wisdom

X-systems and C-systems. Rational and irrational herding. Information cascades and greater fools. It's a lot to take in.

That's without mentioning many of the other cognitive quirks that may cloud a person's judgement. Optimism bias, recency bias, the endowment effect and anchoring can all be factors that steer investors towards the herd.[8]

[7] *'A Simple Model of Herd Behaviour', The Quarterly Journal of Economics, Vol. 107, No. 3 (August 1992), pp. 797-817.*

[8] *Our October 2018 Quarterly Letter, 'Fighting against our instincts', provides more insight into the psychological biases that can affect investors.*

What makes these decisions especially tricky is that following the direction of the herd may be the right move. For instance, aggregating the collective opinions of large groups tends to deliver more accurate results than polling individual experts.[9] This has been called 'the wisdom of the crowd', an allusion (and counterargument) to McKay's work.

Prediction markets and betting lines are obvious examples. If you had to bet your house on a horse race, would you pick the overwhelming favourite or the rank outsider? The sensible bet is to back the front-runner, unless you have convincing evidence to the contrary.

So, the question becomes: how do you know the right moment to stray from the herd?

Always bucking the trend simply for the sake of it is unlikely to be a winning formula in the long run. Amazon founder Jeff Bezos summed it up well when he said: "You have to remember that contrarians are usually wrong."

That's why we advocate independent thinking, not contrarianism. At Rothschild & Co, we make decisions based on our, and our network's, knowledge and expertise rather than taking recommendations from others. We avoid following the herd.

That said, there will be times when we move in the same direction as the herd. That's not because we're following the actions of other investors, however. Our analysis and research have simply convinced us the herd is on the right path.

But we are also human. We're therefore not immune to the deep-seated behavioural biases that influence decision-making. We strive to counter this by creating an environment that not only has robust systems and processes, but also promotes intellectual curiosity and rigorous debate.

Thinking independently

In many democracies, nations aim to achieve a 'separation of powers'. The US, for example, has three main government branches: executive, legislative and judiciary. The president oversees executive functions, Congress handles legislative duties, and the Supreme Court is positioned at the top of the judiciary.

Clear divisions exist between the three, helping to engender trust in the system and preventing any one branch from wielding too much influence.

Our teams work in a similar way. Investment analysts, portfolio managers and client teams work together closely, but they are also actively encouraged to challenge each other's ideas and research. They are structured to provide a layered yet transparent approach to investment decisions.

With detailed analysis and lively discussions, we hope our teams come to view investments through a more neutral lens. This objectivity helps us avoid groupthink and reduce external market noise. Whether we're moving in the same or a different direction to the herd, we want to be confident it's for the right reasons, so we scrutinise every decision for potential biases.

Our bottom-up investment approach looks to add protection against the irrational exuberance that can lead other investors astray. We aren't looking to capitalise in the short term on momentary madness in the market or take advantage of 'greater fools'.

Instead, we concentrate on a company's business model and management, its growth potential, and its sustainable competitive advantages. Companies are only added to the portfolio if their fundamentals are strong and they are trading at a price below what we've calculated they're worth.

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That gives us a clear margin of safety.

As a client, this means your portfolio might not feature the headline-grabbing investments that are attracting other investment managers. Our client teams welcome your questions about this and seek to give you as much insight as possible into our decision-making process. The goal is to share our logic with you and reinforce your confidence in our investment process.

As noted above, we are not trying to be contrarians, but we *are* wary of being dragged along with the herd. While we won't always get every decision right, we will always be clear about our reasoning so that you can see our independent thought in action.

Putting theory into practice

We've talked a lot about the theory behind herding, but let's look at a real-life example to see how our investment principles guard against this type of cognitive bias.

Equipment rental provider Ashtead has been a part of our portfolio since December 2019. Increasingly, organisations are leasing

[9] *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes, James Surowiecki, 2004.*

equipment rather than purchasing outright – a trend that is expected to continue – and we felt Ashtead was in a strong position to benefit from ongoing consolidation within the market.

Our analysis confirmed Sunbelt, Ashtead's North American business and primary revenue generator, enjoyed efficient scale and notable cost advantages over its competitors.

Fighting against the herding response isn't always easy but separating from the group is often necessary.

Prior to investing, we were confident the company would experience healthy growth and continue to capture market share.

However, demand for rental equipment took a heavy hit when the construction industry came under severe pressure due to COVID-19 shortly after. Ashtead's stock price fell sharply and experienced large daily swings as the scale of the crisis began to emerge.

As we've seen, following the herd is an instinctive reaction during times of uncertainty. But we wanted to respond quickly, not hastily, to the pandemic. We revisited our initial analysis, thoroughly reviewed balance sheets and spoke to management teams.

What we found at Ashtead was encouraging. In response to the crisis, the company was well-organised, halving its spending, halting mergers and acquisitions and extending its line of credit. Ashtead also recognised the importance of maintaining its highly skilled workforce by announcing no redundancies, emphasising its long-term outlook.

Ultimately, we estimated the business could withstand an 80% drop in revenue for three consecutive quarters before its cash reserves ran dry.

Not only were we reassured in our initial investment, but we added to our holdings in Ashtead at the start of March when prices fell to very attractive levels. Rather than follow the herd, we chose our own path and made decisions based on our disciplined investment approach.

Since then, Ashtead has performed better than even we expected. By the latter half of 2020, the company's revenues and operating margins were three times higher than their lows during the first wave of the pandemic.

Conclusion

Herding behaviour is complicated. It can be instinctive or deliberate, rational or irrational, selfish or altruistic. What's important is that following the crowd is rarely the best way to make well-informed investment decisions.

Fighting against the herding response isn't always easy but separating from the group is often necessary. By having the right systems, processes and people in place, we give ourselves the best chance of avoiding a herd mentality, while also ensuring we don't stray too far from the pack.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.