

Beware the Herd

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Academics have attempted to identify and predict the rational and irrational behaviour of group think in order to help predict future economic outcomes. Behavioural finance teaches us that herding is a natural human instinct driven by emotional reactions such as greed and fear. But it's also something to be wary of: investors rushing to be part of the latest trend can often lead to bubbles forming in asset prices. Oddly, the bull market which began in 2009 has been characterised by extremely risk-averse investor behaviour, as record low interest rates and economic uncertainty has encouraged investors into defensive sectors in the search for safe havens. This has, in our view, led to crowded trades in certain sectors and stocks on a scale not experienced since the Dot Com bubble in 2000.

Crowding is defined as an over-representation of stocks in the portfolios of active managers: more commonly known as a consensus trade. It can be measured by factors such as institutional ownership (through active bets), sentiment (price momentum and sell-side analysts' ratings) and expectations (earnings forecasts and valuation).

Investors may feel comfortable and secure in these crowded trades but it's important to be aware of the inherent risk in these holdings and to consider breaking from the herd, even when your emotions tell you otherwise. The divergence in valuation between safe-haven assets and all others is very high. You could liken this to an elastic band that's been stretched further and further – waiting to snap back. The consequences for investors taking shelter in these perceived 'low risk' crowded assets could well be severe if we see any unravelling.

Crowded stocks tend to have an asymmetric return profile – incremental positive news is generally of little benefit, because there is little room to improve on already high expectations. Conversely, negative news carries much more downside risk given stretched valuations. The reverse is true of oversold companies; already negative sentiment puts a floor on negative revisions, whilst positive surprises provide powerful impetus on the upside.

Balancing crowded holdings with uncrowded holdings can therefore help to mitigate downside risk by offering diversification through negatively correlated returns.

Technology and consumer stocks are the most crowded sectors globally with their earnings stability and relative growth prospects in a slow-growth economic environment attracting investors. The least crowded global sectors are financials and energy. Financial markets work in cycles: capital is removed from areas that do not provide the prospect of superior returns in the future and only returns after these areas of the market have reset their business models and balance sheets to the new expectations going forward. At this point, these sectors begin to attract capital again.

At Tacit we believe that we are in the early stages of this change for some very large sectors that make up nearly half of global equity markets. This is why we remain positive looking ahead but only because our investment approach allows us to maximise exposure to such areas at the expense of more crowded areas.

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