**Group Behavior: Conformism, herding, fatal attractions.**

**Why are we affected by the conformity bias?**

There are two main reasons why a person’s opinion is often influenced by those of others. The first is the social pressure of conformity which can be a powerful force. As social creatures, we all want to be accepted by others and following the behaviour of the group is an ideal way of achieving this.

The second reason is the common belief that a large group of people can’t be wrong. Even if you are convinced that your particular course of action is the right one, you may still find yourself following the decisions of the crowd believing that they must know something that you don’t.

**Fashions and trends**

There are clear examples in contemporary behaviour that underline the prevalence of our herd mentality with many us following certain fashions that help identify ourselves with others, and them with us.

Trends, whether they involve clothing, hair styles, exercise regimes, diet plans or anything else, are essentially a matter of imitation, with different people copying one another on the basis of conformity.

**Stock market bubbles and crashes**

Herd-like behaviour also manifests itself in the context of global stock markets.

Bubbles and crashes are common features of stock market trading and they arise, largely, due to individual investors following the behaviour of the crowds of people that are either frantically buying or selling certain stocks.

The consequences of herding and conformity on major stock markets can be hugely damaging even on the scale of the global economy. However, our urges towards imitation are generally very difficult to overcome or set aside. Rarely, do many of us, as individuals, wish to be the odd one out and stand apart from the crowd.

**The Nudge Concept**

One means by which experts look to take account of conformity biases and herding instincts is to make use of nudge theory. Nudge theory essentially aims to encourage individuals to make “good” decisions without having to resort to implementing legislation, thereby still allowing individuals to make their own choices.

One famous example, often quoted to explain nudge theory, is that of the men’s urinals at Amsterdam’s Schiphol airport. It seems that signs in the gentlemen’s restrooms, encouraging due care and attention, were failing to prevent wet floors. As a result, staff decided to use the concept of nudge theory to attempt to improve the situation. Innovatively, the image of a fly was placed on the inside of the urinals. This, evidently, focused the minds of the patrons of the said restrooms, giving them a target to aim for, thus nudging them into the correct behaviour and lessening the amount of cleaning required!

**Auto-enrolment**

Another, altogether less novel, example of nudge theory in action is the UK government’s implementation of the auto-enrolment initiative that opens up pension plans on behalf of employees around the country.

Employees can still opt out of their workplace pension schemes but, by making enrolment the default position, their instincts to herd together and copy one another can be channelled towards the positive action of saving for retirement.

**Making choices for the right reasons**

As ever in financial planning, the aim for individuals is to overcome whatever biases or instinctive tendencies might be at play when they come to make decisions that will affect their financial future.

Whether it’s with regard to a workplace pension or an investment strategy of any sort, individuals need to be as fully informed of their options and potential outcomes as possible. A good understanding of all the relevant issues is key in order to ensure that any financial planning is based on sound, rational decision-making and is not dictated by what other people are doing.

### What is Herd Behavior?

Herd instinct in finance is the phenomenon where investors follow what they perceive other investors are doing, rather than their own analysis. In other words, an investor exhibiting herd instinct will gravitate toward the same or similar investments based almost solely on the fact that many others are buying the securities.

### Understanding Herd Behavior

Herd instinct is a mentality that is distinguished by a lack of individual decision-making or introspection, causing people to think and behave in similar fashion to those around them. The fear of missing out on a profitable investment idea is often the driving force behind herd instinct.

### Key Takeaways

* Herd instinct in finance is the phenomenon where investors follow what they perceive other investors are doing rather than their own analysis.
* Herd instinct has a history of starting large, unfounded market rallies and sell-offs that are often based on a lack of fundamental support to justify either.
* The dotcom bubble of the late 1990s and early 2000s is a prime example of the ramifications of herd instinct in the growth and subsequent bursting of that industry's bubble.

Herd instinct, also known as herding, has a history of starting large, unfounded market rallies and sell-offs that are often based on a lack of fundamental support to justify either. Herd instinct is a significant driver of asset bubbles in financial markets. The [dotcom bubble](https://www.investopedia.com/terms/d/dotcom-bubble.asp) of the late 1990s and early 2000s is a prime example of the ramifications of herd instinct in the growth and subsequent bursting of that industry's bubble.

By nature, human beings want to be part of a community of people with shared cultured and socioeconomic norms. Nevertheless, people still cherish their individuality and taking responsibility for their own welfare. Investors can occasionally be induced into following the herd, whether through buying at the top of a market rally or jumping off the ship in a market [sell-off](https://www.investopedia.com/terms/s/sell-off.asp). [Behavioral finance](https://www.investopedia.com/terms/b/behavioralfinance.asp) theory attributes this conduct to the natural human tendency to be influenced by societal influences that trigger the fear of being alone or the fear of missing out.

### Herding and Investment Bubbles

An investment [bubble](https://www.investopedia.com/terms/b/bubble.asp) occurs when exuberant market behavior drives a rapid escalation in the price of an asset above and beyond its intrinsic value. The bubble continues to inflate until the asset price reaches a level beyond fundamental and economical rationality. At this stage in a bubble’s existence, further increases in the cost of the asset often are contingent purely on investors continuing to buy in at the highest price. When investors are no longer willing to buy at that price level, the bubble begins to collapse. In speculative markets, the burst can incite far-reaching corollary effects.

Some bubbles occur organically, driven by investors who are overcome with optimism about a security’s price increase and a fear of being left behind as others realize significant gains. Speculators are drawn to invest, and thus cause the security price and trading volume to climb even higher. The [irrational exuberance](https://www.investopedia.com/terms/i/irrationalexuberance.asp) over dotcom stocks in the late 1990s was driven by cheap money, easy capital, market overconfidence, and overspeculation. It did not matter to investors that many dotcoms were generating no revenue, much less profits. The herding instincts of investors made them anxious to pursue the next [initial public offering (IPO)](https://www.investopedia.com/terms/i/ipo.asp) while completely overlooking traditional fundamentals of investing. Just as the market peaked, investment capital began to dry up, which led to the bursting of the bubble and steep investment losses.

**Fatal Attractions**

Invest in what you know – (that’s Investment ). But could sticking to what you’re comfortable with actually be burning a hole in your pocket?

It’s true that when you know an investment inside out, and the sector it sits in, you’re more likely to successfully evaluate risk and uncover profitable trading opportunities. You don’t have to know what you’re investing in to make money, although it certainly helps.

But just because you know something, doesn’t make it safe. Although it’s easier to achieve diversification than ever before, many investors fall victim to the familiarity bias, where they’re more likely to consider investments in what they know and can easily understand – whether it be the retail sector, oil market or government bonds, for example.

This leaves portfolios with heavy exposure to similar risks and investment cycles, which can mean a greater chance of loss. For example, whilst the slump in oil prices has been good for prices at the pump and those travelling abroad, investors with heavy oil-based portfolios will have had a painful few years as low prices hit earnings and threatened bond repayments.

Investors are also more likely to consider investments at home over other international opportunities. More comfortable with understanding domestic risk and return, this preference for home investments is due to uncertainty over international markets. Yet investors are leaving themselves more exposed to regional economic cycles and currency swings.