Market reactions to the June 23 “Brexit” vote were predictable. The day after the Thursday vote, surprised investors unloaded stocks. On Monday, they unloaded more stocks, the FTSE 100® Index had fallen almost 6% in those two days. Then, having realized the world may not be at an end, they dove back into the markets and UK equities shot up 9.1% in the following week.¹

If you want to compare this behavior to that of a herd of startled cattle, that’s perfectly legitimate. Because investors’ reaction to Brexit was a perfect example of what we call “herding behavior.” One of my colleagues in our retail business wrote about this on our companion blog, Helping Advisors, in 2014, and the content still holds true. Herding behavior is the tendency of investors to follow the crowd, often in disregard of the fundamental data. Just look at some past “facts” the herd was certain about:

- 2006. Enron is doing just great!
- 2014. We’re running out of oil.

We humans may be hard-wired to follow the herd. After all, in 10,000 B.C. we wouldn’t have survived 10 minutes without our group of hunter-gatherer relatives. Today it’s still much easier for us to follow the crowd than risk being an outcast. Even if that means piling into a stock that probably has already seen its biggest gains.

Investors behave in predictable ways as they struggle to overcome their behavioral biases and cognitive challenges. History is littered with examples of how extreme pessimism gives way to gaining popularity and optimism to climax with irrational exuberance before the dreams are shattered and the cycle begins again. When stalking investing outcomes, rather than woolly mammoths, being different may be the way to go. So, whether you’re an institutional investor or an investor working with an advisor, here are four ways to help develop a sound, logical strategy to profit from the herd:

1. **Be contrarian at times.** If everyone is doing A, then maybe the smart choice is B, because herding behavior almost invariably reverses itself. During the summer of 2015, for instance, many investors exited the market on fears of a recession in China, resulting in the Dow plunging 531 points on August 21 according to Bloomberg data. But economic fundamentals hadn’t changed much. By September,
most markets had regained their losses. A wise investor would have likely bought during the dip, going against the crowd.

2. **Understand your motivation.** If you’re considering buying stock in the hypothetical company Consolidated Widget, is it because your friends all bought some? Or because you’ve researched the fundamentals and it seems like a prudent investment? Be prudent.

3. **Be disciplined.** Investors behave in predictable ways and the transition from extreme pessimism to extreme optimism provides opportunities to run ahead of the herd in the anticipation many investors will be slow to incorporate new information.

4. **Be a leader.** This is where investing can make you sweat. It’s easy to make a decision in line with the common wisdom. All those people can’t be wrong, right? But investors who are willing to lead and sometimes go against commonly held beliefs can stand to sometimes reap the benefits. Do your homework. Trust your rationale. Be brave enough to go against the current common wisdom.

5. **See the big picture.** It’s easy to get caught up in the emotion of the moment – that’s what happened to many investors after Brexit. To avoid herding behavior, it’s often better to take a deep breath and look at your long-term goals—an investment strategy that considers years, not just tomorrow. It’s OK to consider making adjustments as market conditions change, but do so for rational reasons, not out of panic or euphoria.

We all can agree that investing isn’t easy. We all make mistakes. But by thinking independently and understanding the behavioral pitfalls of many investors, the rational investor—who is willing to be contrarian when the facts bear out—and ride the wave when appropriate, may stand a better chance of reaching his or her investing goals.

Be brave. Use the herd to your advantage. **The world's largest institutional investors already have.**

1 FTSE / Factset July 4, 2016

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