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James G. Tillar, CFA

Are Crowds Wise or Mad?

By Jim Tillar, CFA

When I joined the money management industry more than 20 years ago one of the first books I read was Charles MacKay's Extraordinary Popular Delusions and the Madness of Crowds. No discussion needed on where he stood on this issue. Moreover, in my second year in the business the stock market declined by over 22 percent on a single day in 1987. No doubt in my mind: crowds and the stock market were mad and irrational.

Over the years, though, I've softened my opinion. The evidence supports the view that the stock market does a pretty good job of pricing stocks with occasional bouts of irrationality. Most stocks are rationally priced most of the time in the stock market. It is only periodically that prices wander far from any reasonable estimate of value.

This observation is consistent with recent research (the most readable example is James Surowiecki's The Wisdom of Crowds) that builds a compelling case that groups make better decisions than individuals, including experts, in a wide range of fields and applications.

One great example of collective wisdom is the game show "Who Wants to Be a Millionaire?" The contestant answers a series of multiple-choice questions with four possible answers. One time during the game the contestant can ask the audience for help. In its prime-time run, the audience came up with the correct answer an amazing 91 percent of the time!

The wisdom of crowds is also evident at two on-line markets: the Iowa Electronic Market, designed to predict the outcome of elections, and the Hollywood Stock Exchange, where visitors wager on box-office returns and the Oscars. The track record of both these prediction markets has been remarkable, especially compared to individual experts.

So if crowds are wise, why does the stock market get it spectacularly wrong sometimes? How in the world could **Priceline.com**'s stock trade near $1,000 in 1999 (it's around $60 today)? One explanation based on this new research is that crowds are only wise when they are diverse and independent.

Usually these two conditions are met in the stock market, but sometimes they are absent, allowing prices to get wacky.

Stock market participants can be classified into two broad camps: investors and speculators. Generally speaking, investors are concerned with value and speculators are concerned with price. Investors have long time horizons, while speculators focus on the short-term. Investors use various methods of valuing companies for the purpose of buying stocks whose price is below their estimate of fair value. Speculators are simply interested in buying stocks with positive price momentum and selling stocks with negative price momentum.

When both groups are active in a stock the price is likely to be a good estimate of value since diversity and independence exist. But there are times when speculators dominate the trading action, forcing out long-term investors and eliminating diversity. During these episodes speculators become dependent on the actions of others (they will buy as long as other speculators are buying, or sell as long as other speculators are selling).

At this point, collective wisdom is lost since both diversity and independence are gone, allowing prices to become distorted. It is not a stretch to envision this dynamic at work in the late 1990s during the technology bubble.

To find mispriced securities the logical application of this stock market model suggests investors look for a lack of diversity and independence in the pricing of securities. Unfortunately, there is no current way to demonstrate in real-time that diversity and independence has been lost in the pricing of securities. My firm is working on a project that will try to address this shortcoming, and we hope to introduce the solution sometime this summer.

In the meantime, it is still worthwhile to use these insights to search for mispriced stocks. Currently, the Chinese stock market is a candidate for irrationally exuberant pricing. Valuations are extremely high. It appears the main reason investors are buying is because prices are rising. If so, diversity and independence are most likely lost, making the Chinese stock market a high-risk investment.

In addition, we have an example on our Web site (twadvisors.com/dbj2007sup.asp) of the thought process we used to evaluate a stock we think is undervalued due to the potential lack of diversity and independence in the stock's pricing.

Jim Tillar is a principal with Centerville-based Tillar-Wenstrup Advisors. Reach him at info@twadvisors.com. 937-428-9700