

Not far enough from the madding crowd

Matthew Edwards observes that much has been written about how we like to follow the crowd.

HERDING HAS BEEN TALKED ABOUT a lot recently. Various examples:

- ◆ the FSA's paper 'Managing risk: practical lessons from recent "failures" of EU insurers' cited 'uncritically following herd instinct' as one of the standard reasons for the disasters considered;
- ◆ the CFO Forum's EEV principles point to a 'herding tendency' (regarding 'the use of similar risk margins between companies') as a weak point in EV reporting;
- ◆ Lord Butler, in his July 2004 report on his 'Review of Intelligence of Weapons of Mass Destruction' in the wake of the Iraqi war and the invisible WMD saga, specified 'group think' as one of the major contributory factors.

These 'herd' dynamics should be of interest to most of us, as they underlie so much of what goes on in the financial markets (as well as in other areas). The most profound thinking I have come across regarding this strange aspect of human behaviour is that of the 'theological anthropologist' René Girard, who has posited a theory of mimetic – in other words, imitative – behaviour as the underlying current of group processes.

Unholy Financial Markets

Recognition of the importance of this facet is not new; long ago Aristotle wrote, 'the instinct of imitation is implanted in man from childhood... he is the most imitative of living creatures'. However, Girard seems to be the first to have analysed the behaviour in depth, and taken it to its unpleasant conclusions.

Humans, runs Girard's theory, generally imitate the desires or behaviour of other humans: if A likes X, then B – in the absence of significant information to the contrary – will also

decide to like X. An actuary might regard this, after a moment's thought, as a practical example of credibility theory: if I don't know much about something, I'll adopt my neighbour's view of it – and this imitative behaviour would seem to be of evolutionary benefit (assuming we ape the desires only of our surviving neighbours!). Girard has expounded his theories in many books and papers (many of them hard to find in English, hence the anthology recommended below), although he generally uses the mimetic model – and its consequent scapegoat/sacrifice safety valve – to shed light on biblical matters rather than on Unholy Financial Markets.

Crazy

On the subject of light and scripture, 'there is nothing new under the sun'. Studies of old financial stampedes can be as relevant as – and often more interesting than – studies of recent market lemmingitis. The oft-reprinted *Extraordinary Popular Delusions and the Madness of Crowds*, by Charles Mackay, is one of the classics of this field. Mackay covers a variety of bizarre 'epidemics', many of them hard to believe now, although we no doubt suffer from contemporary equivalents whose absurdity escapes us.

One craze covered in the book which most readers will have heard of is the South Sea Bubble. This has been the subject of two books published in the past year (another craze?), although I can comment only on one of them: *The First Crash – Lessons from the South Sea Bubble* by Professor Richard Dale.

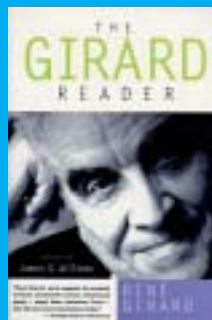
Professor Dale provides a detailed, well-written, and exciting account of the phenomenon, from its start in the attempts by the British government of 1711 to manage its debts to the

crash landing in 1720. Two aspects of the book which I found particularly useful were its initial painting of the social milieu in which the venture found ready acceptance, and its final sketching of the lessons we should take with us. Paraphrasing heavily, 'markets are not rational' is one of the basic lessons that many continue to ignore.

Risk-takers and decision-makers

Moving to a more modern setting, readers may find Luca Celati's recent book *The Dark Side of Risk Management* of interest. Celati writes from a very practical perspective, as an ex-trader who has also held risk management positions and is now the chief investment officer of a hedge fund company. One of the themes of the book is that companies should identify and manage the behavioural patterns of key risk-takers and decision-makers in any firm, and how these individual characteristics interact with areas such as the choice of reporting frameworks and formal decision-making criteria. Although this may seem a slightly offbeat perspective, and one that is sure to suffer the disparagement of most of those at whom it is aimed, the evidence presented in the book – whether from the author's experience or from recognised publications in the field of psychology and behavioural finance – seems compelling.

As might be expected, herding and 'group think' are one of the areas studied in the book, and the relevant chapter is particularly interesting to anyone trying to think through better approaches to measuring operational risk and agency cost – or to anyone interested in King Ptolemy's approach to managing the world's first attempt (250 BC) at scripture translation by committee. There is nothing new under the sun... □



The Dark Side of Risk Management by Luca Celati, FT-Prentice Hall, ISBN: 0273663461

The First Crash: Lessons from the South Sea Bubble by Richard Dale, Princeton University Press, ISBN: 0691119716

The Girard Reader, René Girard (edited by James Williams), Crossroad Publishing, ISBN: 0824516346

Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay, Harriman House Publishing, ISBN: 1897597320