Market Dynamics

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Performance Management System

How Does An Overly Crowded Trade Develop?

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"When Everyone Thinks Alike, No One Thinks Very Much."

Walter Lippmann

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Active investment managers need to know how an overly crowded trade develops The ability to benefit from an overly crowded trade is a skill that active managers need to nurture and develop. The ability to analyze an overly crowded trade helps the investor avoid the negative consequences of an overly crowded trade when it ends, often abruptly.

The term overly crowded trade is just another way of saying that a stock has become a fad or an asset class has become a bubble. The fad starts out as an undiscovered opportunity that starts to produce unusual returns to its investors. The persistent flow of improving financial results or hoped for results has the ability to attract other investors to that stock.

This is nothing more than social proof at work (see *Influence* by Dr. Robert Cialdini). People are buying the stock just because others are buying the stock and they have made exceptional profits and "they must know something because it just keeps going up." The decision to buy the stock is not the result of serious and critical examination of the investment merits of the stock but is largely due to the desire to participate in the profits that other investors have already received from the investment. This is the well-known herd following mentality that is so often observed in the stock market.

On a long-term bar chart of the stock price, the price will follow the shape of a compound interest curve, i.e. an exponential rate of increase. I have observed stocks that increased at a rate of 4% per month for several years. The fad may last for a couple of years but only rarely more than three years. The compounding returns can produce a total price increase of several times the starting value. These are the "three baggers" and "four baggers" that a well known investment fund manager, Peter Lynch, wrote about.

A stock that keeps going up will call forth media coverage of the reasons to explain the price advance and the constant repetition of positive stories in the media can cause even the most critical investors to believe the fundamental story. The PR efforts of the company management probably adds to this positive coverage in the media. Wall Street analysts will almost certainly follow the stock and recommend its purchase. This results in one side of the market becoming overly crowded with buyers.

In a statistical sense, the distribution of daily price changes over a year's time for the stock, becomes extremely skewed to the positive side. When compared to the returns of a large number of other stocks, the fad stock will be positioned in the extreme right tail of the distribution of the returns of all stocks. This can result in a z-score of three or more signifying that this bullish move is truly a rare event.

The buyers are happy with their decision to buy the stock and will almost certainly discuss their reasons for owning the stock with their friends and acquaintances who may also be investors. All of these factors produce a drum beat of positive opinion about investing in that stock. The fundamental reasons for owning the stock become obvious to even the most casual observer. Towards the end of the fad, the market for the stock will become overly saturated with investors who absolutely believe the positive fundamental story about owning the stock.

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