Market Dynamics

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Performance Management System

Social Proof In Bear Markets

Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law

"Buying begets buying And Selling begets selling."

Old Wall Street saying

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Experience shows that social proof is a potent force that can shape investor's behaviors in both bull markets and bear markets. It usually means that trends will be carried to excess as new investors follow along and mimic the behavior of those who came before.

What is social proof? Dr. Robert Cialdini discussed social proof in his excellent book titled *Influence– The psychology of persuasion.* When people face a situation that is highly uncertain and ambiguous they often examine how other people are reacting to that situation and they generally adopt a similar behavior. This is an automatic response and it occurs without even thinking about it.

The stock market certainly fits the bill about being highly uncertain and ambiguous. There seem to be no firm guidelines to control investor's behaviors in the market. The process of continual change makes the outcome of stock investing very ambiguous and uncertain. This is a perfect set of conditions for the operation of social proof.

The history of the stock market is replete with examples of fads and crowd following behaviors that appear to be caused by social proof. It certainly seems to work in bull markets and it is worth considering how it works when a bear market develops.

Stock market investors currently seem to have developed strong feelings of revulsion regarding investments in stocks. This behavior is confirmed by the extremely large holdings of cash in investment accounts. Is this the result of an objective appraisal of the value of individual stocks or are people willing to sell and not reinvest because that is what they believe other investors are doing? It seems that the willingness to sell has become self-fulfilling as a result of social proof. This process has been underway for well over a full year and it became pronounced in the moths of October and November of 2008.

In his famous book *The Crowd*, Gustave LeBon described the final stage of crowd behavior as "contagion." The idea spreads through the members of the crowd like a disease and those who have already succumbed to the idea spread it to others.

This aspect of contagion seems to work in bear markets as well as bull markets. The number of investors willing to sell just because others are selling tends to feed on itself as the market goes lower. Investors who were completely unwilling to sell their stocks when the market was higher, now come to believe that the proper course of action is to sell out. At some point this aspect of social proof tends to reach a maximum, usually right at the low in the market. When the majority of investors come to believe they should sell their stocks, the price level has probably reached its nadir. This sometimes results in what seasoned observers call a "selling climax." A 'selling climax" is often a crash-like decline in the overall market. It is not a necessary condition for a market bottom to develop but it is usually a very good indication that the lows are being made.

The media play an important role in the contagion of social proof. The media feels compelled to provide reasons for why the market declined. During a persistent decline, this steady drum-beat of negative explanations takes on a sort "propaganda" like quality which investors eventually accept due to repetition, as the true reasons behind the decline in stock prices. This sets up the conditions for social proof to produce widespread selling behaviors. Investors know what others are doing, they know they are selling because the market is declining. Now the media provides believable reasons for the selling behavior.

It is likely that the stock market decline of last October and November was just such an example of extreme selling pressure brought on by social proof. If that proves to be true, the lows of November should hold and the contagion of selling pressure should subside.

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