The Wisdom of Crowds

"Nobody goes there anymore. It's too crowded." - Yogi Berra

As the summer draws to a close, we Floridians are in transition. We will soon stop complaining about the heat and start complaining about the crowds. While it may be impossible to be sanguine about the oppressive summer heat, we should keep in mind that the fall and winter crowds actually provide us with some useful benefits. The crowds of tourists contribute a large share of revenue to the Florida economy, and they help to pay for a significant portion of our state infrastructure. It might be difficult to keep this in mind when your favorite restaurant is booked and the highway looks like a parking lot, but the crowds do take a financial burden off of the locals.

Investment markets also reap the benefits of crowds, and the wisest investors embrace the investment crowd because, as a whole, the crowd provides us with very valuable information regarding the fair pricing of assets. In fact, the investment crowd generates a peculiar and universally beneficial phenomenon known as the *wisdom of crowds*.

The wisdom of crowds is defined by Investopedia as "the idea that large groups of people are collectively smarter than even individual experts when it comes to problem solving, decision making, innovating and predicting." In an investment context, this means that, when attempting to determine the fair price of a stock or bond, the aggregate estimate given by the crowd (the current market price) tends to be the best estimate of the fair price. In other words, it is very difficult for any single investor, even an expert, to be wiser than the wisdom of the crowd.

This phenomenon may seem odd or difficult to believe at first, but consider this: For every buyer of a stock, there must be a seller. So, by definition, half of the market participants think the stock is a good buy and half think it should be sold. With billions of shares being bought and sold each day, the diverse opinions of thousands of investors are fairly reflected in the resulting stock price (this is what your high school chemistry teacher would cite as an example of "equilibrium"). This equilibrium price reflects all of the information available to the crowd, so, in order to beat the market, it is not enough to simply outguess the average investor; you (or the expert you are paying) need to outguess *the collective wisdom of all other investors in the market*, and this is truly a Herculean task.

The wisdom of crowds is more than just an interesting idea; there is strong data supporting it. For instance, a 2017 study conducted by Dimensional Fund Advisors indicates that only 17% of stock fund managers and only 18% of bond fund managers were able to beat their respective markets over the latest 15-year period. In addition, the study indicates that those few managers who do outperform over a given time period tend not to outperform in future time

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periods. Thus, there is very little consistency around any ability to outperform the wisdom of crowds, and it is likely that most of those experts who did happen to outperform the crowd did so due to luck rather than skill.

The failure of the experts to beat the crowd has profound implications for an industry in which the experts are paid large sums of money for their purported ability to do precisely that. As more and more investors have embraced the wisdom of the crowd instead of the experts, an investment style known as "index investing" has grown in prominence. Instead of attempting to *beat the market*, an index strategy simply *owns the market* by holding all of the stocks or bonds in a particular market sector. Indexing is a low cost, effective strategy that has a high likelihood of outperforming the more expensive "active" strategies of the experts.

Index investing is like taking the train into Manhattan every day: It is boring and not at all sexy, but it gets the job done reliably and you arrive on time. Active investing is like foregoing the train and driving into the city: You might look more fashionable along the way, and if *everything* goes right you might arrive a bit earlier, but if *anything* goes wrong, you will be late, and possibly very late. If you are like most people you are not willing to trade a small chance of getting slightly ahead for a large risk of falling far behind; you should take the train to work and you should invest with an index strategy.

In the end, the choice is a simple one: Why would you pay one expert for his or her opinion of the fair value of a stock when you can get the aggregate opinion of all of the experts in the crowd just by looking at the stock's current price? By choosing an index investment approach, you are benefitting from all of the research and brain power of every analyst in the field on every security in the market, and the cost is far less than an active approach. You are embracing the wisdom of crowds and allowing the power of markets to work for you to generate real wealth over time. Try to keep this in mind when you are caught in traffic next February; the crowd provides benefits too.

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