

## Bank Losses and the Wisdom of Crowds

The nationalisation of Northern Rock, the collapse of Bear Stearns and the news that the Royal Bank of Scotland needs to raise fresh cash from its shareholders gives a clear insight into the extent of the problems in the banking sector at present.

Whilst these troubles can be blamed on reckless lending practices and problems in the wholesale lending markets on one level, the root cause is something we feel goes far deeper into human psyche and is a factor that we believe investors would be wise to bear in mind - the perceived wisdom of crowds.

If you are the CEO of a major bank and your competitors are pushing the envelope and lending further and further down the credit risk spectrum, gaining volumes and margins and profiting as a result, would you be principled enough to continue to restrict your own lending practices? After all, if all of your competitors are doing it, and profiting from the practice, it must be OK and no-one wants to be the black sheep, stand out from the crowd or disappoint their shareholders, particularly when the consensus view is held so strongly.

Thus, even intelligent individuals, when placed in pressurised or challenging conditions, can act in a manner which appears rational from an individual point of view at the time, but when viewed collectively or with hindsight is just plain daft. Consider the bubble in Internet shares at the turn of the century. Did anyone really think shares in new internet companies with little by the way of revenues or assets and certainly no profits could be worth tens or sometimes hundreds of millions of pounds? Probably not, but the share prices kept rising so investors kept buying until the party ended.

This is not just a recent phenomenon either, the book *'Extraordinary Popular delusions and the madness of Crowds'* written by Charles McKay and published in 1841, charts the extreme money manias of the time including the great south sea bubble and tulip mania, investments that look crazy with hindsight but which would have appeared incredibly compelling at the time.

So what are the lessons for investors? Firstly, the crowd is not right all of the time and independent thought can be much more profitable. US investor Warren Buffett has become the world's richest man on the basis of being fearful when others are greedy and greedy when others are fearful. Secondly, actions that appear rational at the time can often appear less so with hindsight, so taking a considered and sometimes longer-term view often helps.

These are all principles with which we manage investments for our clients and which help to ensure performance remains healthy over the longer-term. To find out more about Cave & Sons range of investment services please contact Ian Burrows on 01604 621421 or email [info@caves.co.uk](mailto:info@caves.co.uk)

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