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Understanding human behaviour can fuel our returns

by Gary Moglione

This week, an innocuous announcement from BP about temporarily closing a handful of its petrol stations due to a driver shortage caused panic buying and fuel shortages across the UK. In March, I wrote a blog called "Why we are all hard wired to be bad investors". This week's events are a good example of some of the behavioural inefficiencies highlighted. It is worth looking at the psychology of panic buying events and how these behaviours read across to stock market movements.

If we look through history, it is littered with panic buying events. Some are more understandable, such as food and medicine during the World Wars, Spanish Flu and COVID 19 pandemics, and some more surprising, such as ammunition in the USA when the public feared increased gun regulations. In 1973, a joke on the Johnny Carson show sparked a panic buying spree of toilet rolls in America that created four months of shortages. More recently, everyone will remember the great toilet roll grab in the early months of 2020.

There have been a few studies into panic buying events and many point to heightened anxiety at times of uncertainty. Some have compared it to the basic animal instinct of foraging in that we have an inclination to collect and store food, but we can broaden that instinct to wider products that represent our orderly society, such as fuel and toilet roll. Regardless of what the trigger is, the act of panic buying is driven by the emotions of fear and greed; fear of scarce resources and greed in the form of buying more than you actually need.

These behaviours are inherent in financial markets and can be exploited. At times of peak market stress and uncertainty, fear causes panic selling. Valuation becomes irrelevant as investors rush for the exit creating a powerful downward spiral. On the opposite side, greed becomes apparent at times of market euphoria.

Similarly, valuation becomes irrelevant as more and more market participants become over-confident and rush to buy the latest success story. Warren Buffett has made a career from taking advantage of these behavioural inefficiencies. "Be fearful when others are greedy and greedy when others are fearful" is one of his many famous quotes that help to understand his thought process when investing.

In conclusion, the petrol shortages are a further reminder of our behavioural inefficiencies that lead to a loss of focus on the true value of assets. This results in investors overbuying and overselling at extreme points in the cycle. By focusing our attention on intrinsic value and making investment decisions based on whether the price is above or below that value we should be protected from our behavioural biases. Buffett's fear and greed mantra has always struck a chord with me. In my view, adhering to that principal is extremely difficult to implement as you need to work against your most basic instincts. However, if implemented successfully, the rewards can be exceptional. It is not easy to buy stocks during a crisis or sell into a euphoric market. As we cannot predict the future, our timing won't be perfect, resulting in plenty of self-doubt over the short and possibly medium-term results, but exploiting behavioural inefficiencies of humans frequently results in exceptional returns for long-term valuation focused investors.

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