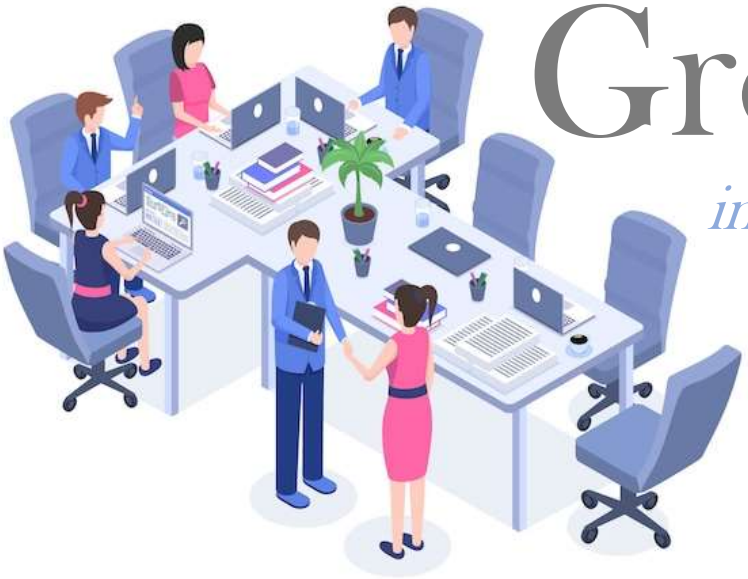

Groupthink *in* Investment Economics

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Groupthink in Investment Economics

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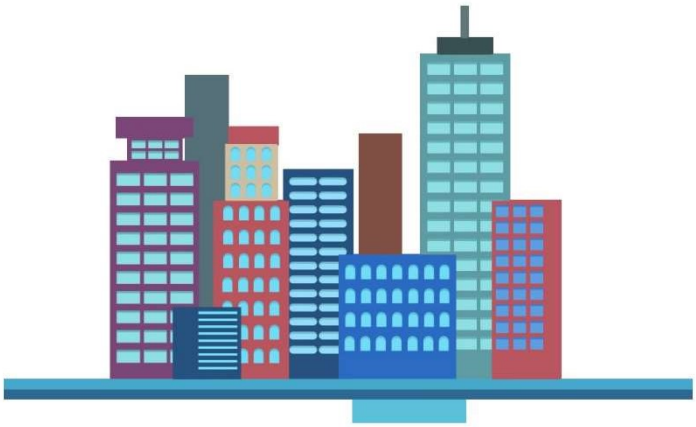
Herbert M Barber, Jr, PhD, PhD serves as the Managing Partner and Chief Investment Officer of Xicon Economics. For over 30 years, he has provided advisory, consulting, and management of large capital investments in the private and public sectors, totaling over $125 billion. Dr. Barber holds 5 academic degrees, including two research doctorates.



Groupthink, a behavioral phenomenon occurring within a group of individuals whereby consensus is reached collectively by avoiding controversial constructs. While the theory is nothing new, scientific validity has yet to be fully developed and accepted by scientific researchers working within the various areas of behavioral science, let alone the educated population at large. Nonetheless, ideas surrounding groupthink have far-reaching tentacles that cross disciplines and multi-disciplines in business, management, finance, economics, engineering, science, education, healthcare, and every other conceived discipline or activity where persons regularly work collectively to make decisions. Considering this construct even further, an argument can be made that as a people we collectively work to this end in some manner simply to exist. That said, doing so almost flies in the face of capitalism, where only the strong survive. Subsequently, herein, we examine groupthink under the umbrella of investment economics, especially how the dynamics of such ultimately impacts investments, themselves.

Dr Irving Janis, a research psychologist, coined the term groupthink, and today, some 50 years later, the debate continues, one, as to whether evidence surrounding groupthink exists to pass scientific scrutiny, and two, if so, whether groupthink should be considered a positive phenomenon or a negative phenomenon during the decision-making processes within groups. For our purposes, we will consider groupthink agnostically, having formed neither a positive nor negative view of the construct.

To this end, investment economics crosses multiple disciplines. Investment economics, or *financial economics* if you will, lies at the intersection of engineering, finance, and economics. Then again, finance stems from the field of economics, and still further, economics stems from sub-sectors of engineering. That said, it can also be argued that financial economics crosses into the fields of mathematics and statistics, as these fields remain fundamental to all fields associated with analytical inquiry. Notwithstanding, suffice it to say, investment economics remains a complex field involving an infinite number of dynamic variables with which we seem to want to wrestle from a static perspective. And, as soon as we believe we have estimated how variable A acts upon variable B, variable C enters the analytical mix disproportionally affecting both variables A and B. Likewise, after we wrestle through the effects of variable C, variable D enters the mix, setting us back in our understanding of variables A, B, and C. If chaos is the father of investment economics, surely complexity is its mother—and it is with these forces we wrestle as we attempt to tame the beast, for without alpha, beta does not matter.

Assume for a minute that you are Dr Maggie Marshall, a senior investment researcher for a large investment firm. You earned an undergraduate degree in engineering, master's degree in computational economics, and a doctoral degree in engineering economic systems. You have used that education the last several years to make decisions that have far-reaching financial consequences on companies, institutions—and moreover, people. Today, it is the job of your team to determine whether the firm's strongest hedge fund should invest $800 million into Microsoft (MSFT) long, a well-known equity that has served your firm well over past years; as such, your firm intends to hold the equity long, rather than shorting it. Consider to yourself a few of the interactions that invariably will be at play during this decision. How will you conduct the financial analyses of the Microsoft, itself? Which methods will you use? How will you conduct the analyses and modeling of the pricing data? How will these analyses be conducted? Will you develop dynamic autoregressive models, Monte Carlo models, or use some other method? How do you plan to calculate risk? Should you place another member on your team who is an expert in risk engineering? After all, calculating beta coefficients, volatility, Sharpe ratios, and other risk measures only goes so far; perhaps you need to model economic data, as well, such as GDP, unemployment, and inflation, and if possible, causally tie these variables back to your pricing models to potentially serve as independent variables in your models.

For me personally, these questions can be addressed more quickly working independently, rather than involving a team of experts and wanna-be experts who all have opinions. Of course, the idea of groupthink is subjugated in a group of one. However, in larger investments, say over one hundred million dollars, it is wise to consider input from other experts, if for no other reason but to review thought processes, analyses, modeling, findings, and recommendations. Hence, groupthink now becomes a participant in the decision-making process.

So, do we allow any potential benefits of groupthink to enter the decision-making process, or do we take every effort to avoid it altogether? Every business should consider this question. Our recommendations have serious consequences, consequences that are far more easily seen in the aftermath than the hype; most persons enjoy the buying, but in failure, we stand alone. Poor decisions on our part may wipe out the pensions of countless persons who have worked a lifetime to have those monies, or perhaps our poor decisions may destroy a single investor who has gone for broke in a last-ditch effort to right his company. The investment scenarios are endless, and the risk is great, often even greater than the sum of the parts.

Whether the investment is the $800 million we referred to earlier or a million dollars, the decision to invest should only be rendered by subject matter experts with deep understanding into the analytical approach and execution. In groups however, we rarely find deep expertise; rather, we find opinions, and very often those opinions are backed with little more than persons wanting to be heard. And our friend Dr Marshall has limited patience working with persons with opinions grounded in nothing but one wanting to be heard. However, avoiding groupthink is nearly impossible in most decision-based scenarios, especially given that decisions today are more often made through consensus rather than raw expertise. Worse, decisions today tend to be more about pleasing the masses than pleasing those with the greatest risk. In fact, societal norms have moved so far to the left where everyone's opinion matters, persons holding the greatest risk must remain cognizant not to be overtaken by a group's feelings and opinions; disregarding such may be costly. Remember, the dog that barks the most, or the loudest, is seldom the wisest in the pack, especially when standing next to a grown bit bull.

A central theme of groupthink centers on status quo. When challenged, groups tend to opt for status quo, the tried and true. If Microsoft has returned 38 percent the last few years annually, the masses will opt to continue investing in Microsoft, despite sound analyses to the contrary. Why? It is safe. "It has served us well in the past. Why would we expect it to switch course?" For an expert to suggest that Microsoft's market cap is expected to decrease over the next two years by 25 percent is contrary to the news the group wants to hear. Such discussions can rapidly turn the tide against the expert, leaving him defenseless with no support but the proof within his models. In our personal experience with similar situations, after our recommendation is thwarted and time has passed, only then can we look back and silently say, "I told you so." Unfortunately, by this time, the investment, or not, is lost.

Groups almost always steer their decision toward status quo, the path of least resistance, even when doing so comes at a steep price. Your team previously made a poor decision that has cost your company millions of dollars, yet the decision to change, well, nothing, will indeed be the decision your team renders; we have witnessed this decision countless times with countless groups. So, the company will continue to lose more and more, as it rides the beaten horse down the blind road of death.

We recently demonstrated that a small group should invest some $10 million in a hedge fund we projected to continue earning a return over 24 percent. But after much discussion and consideration, what was the group's decision? The easy route; continue holding the money in a fund earning 4 percent. After all, doing so was a known quantity to the group. That four percent was there, or so they thought. Cost of their decision? Around $3 million, and this is only the first year. In two additional years, they likely would have doubled their investment.

Along with opting for the status quo, groups often debate comfortable alternatives. Besides, they find it difficult to dismiss the idea that they are not the expert in everything. Such especially holds true if the group is formally educated but nowhere to the extent necessary to render sound decisions regarding investment strategy. This explains why we often see weak group or corporate leaders retain hard-fast followers, or at most, soft-spoken leaders, rather than strong outspoken leaders, as strong outspoken leaders challenge them, and despite all, the weak leader will protect his ego at all costs. As such, most challengers are relocated to remote worksites or terminated, altogether, allowing the group to consider more comfortable alternatives without a sound understanding of the methodologies nor analyses necessary to render complex decisions. The group can now merely attempt to conduct due diligence in reviewing softer alternatives, while looking for an excuse to dismiss analytically sound recommendations they do not understand. They give the appearance of not kicking the can down the road toward status quo, but their soft review processes and poor decisions result in just that. Remember, weak leaders with fragile egos always surround themselves with persons who will not challenge them. Hence, the company will never reach its potential, as an organization will never successfully outgrow its collective intellectual capital; rather, it will seek more comfortable alternatives during complex investment decisions to those they do not understand.

A few years ago, we met once again with city officials regarding a pending investment decision that would yield millions of dollars. After several meetings with them, they voted to do nothing, always an alternate to a sound decision. But this is not the point of the story. After the vote concluded, a citizen asked a city council member what the vote was "about," to which the city council member replied, "I don't know, but we don't need it;" hence, one reason the city will never realize its potential. Ignorant people make ignorant decisions. The cost for casting such a foolish vote was into the hundreds of millions of dollars. As previously stated, a group or organization will never successfully rise above its collective intellectual capital. Group and organizations must never reframe from incorporating strong intellectual capital into the mix to challenge current wisdom; it is a necessary evil despite that such likely will shatter the fragile ego of the weak leader.

Groupthink can be a dangerous catalyst for decisions with results that last without end. In our experience, groupthink most often causes more harm than good, especially in investment decisions. Allowing groups and leaders to dismiss recommendations beyond their knowledge base and current level of understanding comes with a steep price.

Xicon Economics developed mathematical models to forecast market conditions, investment returns, and tax ramifications for a highly contentious multi-billion-dollar initiative. Their work is highly complex and very important in our decision to implement this financial undertaking.

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