The Wisdom of Crowds

By Paul Doggett

James Surowiecki wrote a book called The Wisdom of Crowds. On his publisher's website he answered some questions about the book and about crowds. I found this Q and A excerpt interesting so I'd like to discuss it here.

Surowiecki was asked: Under what circumstances is the crowd smarter?

His answer was: There are four key qualities that make a crowd smart. It needs to be diverse, so that people are bringing different pieces of information to the table. It needs to be decentralized, so that no one at the top is dictating the crowd's answer. It needs a way of summarizing people's opinions into one collective verdict. And the people in the crowd need to be independent, so that they pay attention mostly to their own information, and not worrying about what everyone around them thinks.

Let's pick up on these four points and apply them to the stock market.

1. Diverse. The U.S. stock market is diverse, people bring different information to it and they express their different opinions and their different levels of knowledge and expertise through the price they buy and sell at, in the market. So we know that we have a diverse market and according to Surowiecki, this quality in a market or a crowd, helps to make it smart.

2. Decentralized. Most stock market's are decentralized and are left up to their own devices to establish prices.

3. Collective verdict. The collective verdict of the crowd is often a smarter decision than the decision of the individual. In the market we could say that the collective verdict is demonstrated in two ways, firstly, through trend direction and secondly, through the closing price of individual stocks.

4. Independence. The final quality needed in any crowd to help differentiate a smart crowd from a dumb one is the independent thoughts and actions of the individual within the crowd. It links directly back to the first quality of Diversity. When you get everyone acting independently, you get diversity and when, through this diversity, you get a common theme developing, such as a bullish trend, then you know that there must be something to it, seeing so many people independently came up with the same answer. I would say that our market exhibits this behaviour.

Having qualified and expanded upon Surowiecki's four qualities, I think we can safely say that the crowd within our stock market is a smart crowd as opposed to a naive one and I raise this point deliberately because so many commentators tell us that the way to be successful as investors is to go against the crowd. They often suggest that we go it alone and be independent. There is nothing wrong in being independent per se, (in fact I can use myself as an example and say that over the years I have developed an independent technical approach to the market), but if you're independent decision making takes you in *completely the opposite direction* as the rest of the market (EG. being bullish in a bear market), it doesn't seem to be a smart decision.

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