Surowiecki, James – The Wisdom of Crowds

Doubleday, 2004, [Behavioural Finance] Grade ★★★★★

The mob is often seen to lack both a sense of reasonable proportion and an ability to balance multiple inputs. Those who have lived through the recent financial crisis would probably sign off on a similar view of how collectives function. Yet, the top rated analyst has a curious difficulty in beating the collective when it comes to consistently making better than average predictions of quarterly corporate profits. In some instances even the most knowledgeable expert is losing out to a mob that in other instances goes berserk. Esteemed business journalist James Surowiecki has written this fascinating book on the first kind of situations, on the wisdom of the crowd.

The key difference between the wise crowd and the madding mob is the circumstances. Under the right circumstances large groups consisting of less informed or even irrational persons can be surprisingly intelligent and often more so than experts. The wisdom of the crowd is really the result of ideas competing. The required set up is a) diversity in terms of perspectives, interpretations of situations and in terms of models for predicting outcomes, b) independence to make sure that the mistakes people make do not become correlated but also to increase the probability of that people will unveil unique information and c) a certain amount of decentralization to allow specialization but also coordination. Further, there must exist some kind of accumulation mechanism that generates a collective decision out of the individual views of those included in the group. In the stock market this mechanism of course is the market pricing mechanism and the economic incentives for those who make the right call.

With the right set up the best from the individuals in a group are accumulated as the errors individuals make will be uncorrelated and hence will not matter. The estimate from each person in a group consists of both correct information and errors. Independent errors will cancel out in total and you will be left with the aggregate of correct information. The quality of the estimate is then up to the amount of real information the members of the group possessed. Often this is surprisingly much, as long as there is true diversity among the members. Translated to a market environment the wisdom of the crowd is what makes the market so called efficient, it's what makes arbitrage such a powerful force.

This is a book on popular social science, not really on stock market functionality. Yet few other books explain the nature of the equity market better. Sometimes journalists keep the newspaper style of writing when they write books with less compelling results. Not so Surowiecki. The Wisdom of Crowds is a joy to read. The tone is pleasant; you flow through the pages but without feeling that substance is being sacrificed. The book contains of two parts where the first presents the workings of the wise crowd and the second brings forward some caveats.

The title of the book is chosen to contrast the 1841 classic Extraordinary Popular Delusions & the Madness of Crowds by Charles MacKay. If I have any criticism of Surowiecki's book it would be that he doesn't discuss the madness of crowds enough. You need to understand both sides of the coin to understand markets. Financial markets never fully satisfy the criteria that make crowds wise. Depending on the group psychology of the moment diversity and independence is either sufficient or breaks down almost completely with booms and busts as results. This ebb and flow between close to efficiency and full blown irrationality is in my opinion the key charactereristic of the market and also the key to making money in equities.

This book completes a huge part of the puzzle of stock markets. You really can't do without it if you seek to comprehend how things work.

Mats Larsson, December 19, 2011

Others may quote and refer to the contents on this website provided that they have the author's consent and proper reference is made to investingbythebooks.com.