Le Bon, Gustave – The Crowd: A Study of the Popular Mind

Dover Publications, First edition 1895, [Behavioural Finance] Grade ★★★★★

There are a number of books that portray financial bubbles and crowd behaviour. This from 1895 is the best one even if it doesn't specifically touch on the financial markets. The Crowd by the French sociologist Gustave Le Bon covers a number of topics such as how individuals adapt to the group view and suppress their own knowledge, how groups hinder analysis and promote "stories", the way groups make decisions and how they handle persons with a contrary view of events. The points Le Bon makes made huge impressions not only on Sigismund Freud, but also on both Hitler and Mussolini who used them to control the masses.

The Book is divided in three parts. You can leave the third unread. It deals with classifications of different kinds of crowds with examples which very much relate to the 19:th century and also displays a little too much of Le Bon's fear of socialism. I'm no friend of socialism but this feels dated. The first two parts are at the same time extremely cynical and completely brilliant. Even if the language is old-fashioned it becomes wholly clear for every reader that group psychology hasn't changed a bit in 115 years. Any study of crowd behaviour should start here.

There are too many interesting topics in the book to cover in a review but one of the important ones is how a collective mind, separated from the individual minds of those constituting the group, forms as the individuals repress traits and knowledge of their own. Temporarily the individual mind could almost be dissolved. As the incorporation in a group is driven by feelings and the very emotional state makes analysis extremely difficult the collective mind is emotionally driven.

As the intellect is pretty much blocked in this emotional state, differences in individual intelligence don't matter hugely when it comes to who will form a part of this collective mind. In a way it is only the stupidity of the members in the group that is accumulated.

Despite being in an emotional state, without ability to judge proportions or take in contradictory information the crowd is very swift in making decisions. The collective mind is affected by colourful stories that play on feelings like greed, anger and fear. There are no buts or maybe's. Everything is black or white. The group will react to any new important or unimportant external input without reflection on the plausibility of the action. Further, a crowd craves for a leader. As the self of those in the group is supressed the ego of all the individuals is projected onto the leader. Hence the aggressive defence of the leader - people are really defending themselves.

I could hardly put the book down and it had a huge impact on how I understand crowd behaviour and thus financial markets. To get a fuller picture however, you have to see the other point of view. At times under the right circumstances crowds can be ever so intelligent as described in for example James Surowiecki's book The Wisdom of the Crowd. The crucial swing factor is the amount of diversity in opinion that the crowd psychology allows for the moment. This ebb and flow between close to efficiency and full blown irrationality is in my opinion the key charactereristic of the stock market and also the key to making money in equities. If the market would be fully efficient there would be no point in active investing - most people realize this. But if the market was always fully irrational then there would be no convergence towards fair values or other trends and this would also take away the point of active investing.

Even if the book handles crowd behaviour in general, the equity investor will on almost every page find quotes that remind him of situations he has encountered on the stock market. He will wish that he had read the book earlier in his career so he could have been less influenced by the collective, and often faulty, mind of the crowd.

Mats Larsson, December 20, 2011