Keynesian Beauty Contest

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One of my favorite investing anecdotes is by the late economist John Maynard Keynes. Not only was Keynes a brilliant economist, he was also a great investor. Between 1924-1945 he managed the Chest Fund for King's College. During the eighteen-year period, the Chest Fund achieved an average annual return of 13.2% compared to the UK market, which remained flat.

The Keynesian beauty contest is often used to explain price fluctuations in the stock market. The story goes as follows:

In a fictional newspaper beauty-judging contest, entrants are asked to choose whom they think possess the most beautiful faces from a hundred photographs. The winner is the person who is able to select five faces that most clearly match the consensus of other participants. The smart player recognizes that his criteria of beauty are irrelevant in determining the contest winner. A better strategy is to select those faces the other players are likely to fancy. This logic tends to snowball. Thus, the optimal strategy is not to pick those faces the player thinks are prettiest but to predict what the average opinion expects the average opinion to be.

This little story explains the 'greater fool theory' and that the value of many investments is determined by herd-like 'animal spirits' of speculators. Simply stated, a sucker is born every minute and he exists to buy your investments at a higher price than you paid for them. As a result, it is perfectly all right to pay five times what something is worth as long as you can find some fool to pay seven times what it's worth. An example of this irrationality and excess happened in the 1990s during the dot-com bubble. We all know how that ended.

My point is that speculating – outguessing the reactions of a fickle crowd – is a very dangerous game. Skyrocketing valuations that depend on the madness of crowds always succumb to the financial law of gravitation. Remember that trees don't grow to the sky. Ben Graham puts it best when he said:

> *"The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage."*

Lastly, it is not impossible to make money in the market. What is hard is to avoid speculative binges. Next time someone offers you the silver bullet to get-rich-quick in the market – zip up your wallet. It is an obvious lesson, but one frequently ignored. A good book to read is 'Extraordinary Popular Delusions and the Madness of Crowds' by Charles Mackay. It reminds us that while history does not repeat itself, it does rhyme.