OUTLOOK MONEY Profit Business Outlook Traveller

Stocks / Expertspeak

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Behave-knots

Irrational decisions lead to losses in the markets. Which behavioural patterns lead to imperfect calls? What is the way out?

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In the Bull Run, all the available information on the economy was positive. Stocks were representative of profits only. Now, all the available news is negative and stocks are representative of risk. The short-cut of not processing information made investors buy stocks earlier as a herd at any price. Now, the herd is selling stocks and fleeing to safe fixed income investments.

You might have lost by following the herd. This heuristic (predictable and systematic error in evaluating an event) of herd mentality happens when self-doubt and market noise make investors do what others are doing even if their own rationale says otherwise.

You might also have lost due to availability heuristics: basing decisions on readily and vividly displayed information. Media plays an important role in disseminating such information. Decisions based on representativeness or similarity, known as representative heuristics, also lead to losses. If a company in a particular sector shows outstanding results, then the laggards in the sector catch investor fancy. Mental heuristics is when the brain does not process the full information. This leads to biased investment decisions.

Companies get into stockmarket indices because of their size and not quality and profitability. But the movement of indices has become representative of the markets. Is it right to judge the health of the market by just a few large-cap stocks?

Stockmarkets are unpredictable because its various participants sway between greed and fear and take decisions out of their heart and not their mind. If we are able to understand this irrationality and take decisions out of our mind, we can win in the stockmarkets.

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Do the opposite when the herd is selling stocks. You lost earlier because you paid exorbitant prices for stocks. Now you are getting stocks very cheap. How can you not buy them?

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The simple trick to be successful is not to repeat the mistakes of the past. Do the opposite when the herd is selling stocks. You lost earlier because you paid exorbitant prices for stocks. Now you are getting stocks very cheap. How can you not buy them?

Investors have been nursing their losses and this has led to loss aversion. They prefer fixed income securities over stocks, sell winners and hold on to losers. However, the loss has already accrued. It does not accrue if one sells. Investors hope that dud stocks would move up once the market picks up. However, there are excesses in every bull market and investors chase fancies and pay fancy prices for the same. Expecting Reliance Power to come back to its issue price of Rs 430 or DLF to touch its peak of Rs 1,250 with improvement in the market sentiment is living in a fool's paradise.

Every government is announcing economic bail-out packages. However, a prudent investor should be worried about the effect of this excess liquidity in the system. Within a couple of years, we could see the ugly head of inflation and even hyper-inflation. Now what better hedge against inflation can there be than stocks? Fixed deposits or fixed income securities will keep money invested in them intact, but will also drastically erode its purchasing power.

Investing in stocks would do well for investors as they are available today at bargain prices. Moreover, stocks are the most tax-efficient asset class: dividends and long-term capital gains are tax-exempt. The challenge is to choose the right stocks on the basis of a competent fund manager's advice. How does one identify one? Check if he himself is an investor and has a passion for stocks. If yes, there is no need to check his educational qualifications. Stock picking is a discipline.

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