Keep 'forecasts' for the weather

As an analyst's job is to analyse and not forecast, it's time individuals used common sense approaches for picking stocks

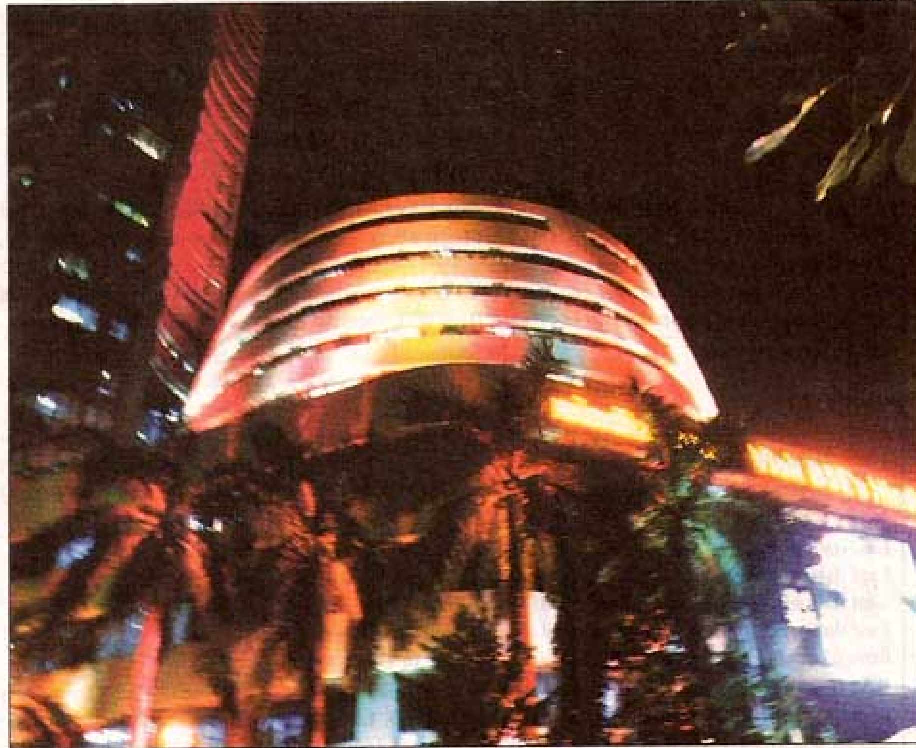
We are going through turbulent times and investors have lost heavily as they had based their investment decisions on forecasts of the so-called experts. My experience in the markets has given me the humility to accept that there are no geniuses in the markets. It's the media who makes them (experts) or a short spell of luck.

Let's go back just six months in time. We had practically most of the brokerage reports recommending an array of stocks with very optimistic price targets. We had mutual fund managers going on marketing trips and giving rosy picture of the economy and the opportunities in the stock markets. Stocks were a fancy.

Now, the same stocks which were recommended as "buys" are recommended as "sells" by the same broking outfits. Their analysts say so. How can an investor hope to make money when he buys when the prices are high and sells when the prices are low? He would have been better off had the broking outfits recommended them as "sells" six months back and "buys" just now.

This brings us to an important conventional wisdom: can analysts predict the future? Their job is to analyse and not to forecast. However, we have a money-spinning financial industry where lay investors make their decisions based on the forecasts or predictions made by the analysts. Not only that, the sophisticated investors also fall prey to the predictions of the so-called experts or analysts.

The 6th century BC poet Lao Tzu observed, "Those who have knowledge don't predict. Those who predict don't have knowledge." How true is this if we look at the state of the financial health of investors today? One would do well to keep in mind these words of wisdom when making investment decisions based on media reports, TV shows, expert seminars and lectures among others.



Uma Kadam

There have been two strong behavioural biases that have worked in poor forecasting by these so-called experts. One is over optimism and the other is overconfidence. When times were good and the stock markets were rewarding mediocre stock picking, people were very optimistic on the future of the economy and the stock markets. The early gains made them overconfident of the knowledge on the stock markets and the economic fundamentals. It also gave them the overconfidence in their own ability to ride the stock market waves.

These behavioural biases did not even spare the captains of our industry.

India Inc was on an acquisition spree. Take the instance of Tata Steel taking over Corus when the steel prices were at an all-time high, resulting in paying an unduly high price. Similarly, we had Tata Motors acquiring Jaguar and Land Rover at the height of an economic boom. The markets have already started punishing these stocks.

street smart
PARAG PARIKH

In the last two years, we had Jet Airways acquiring Sahara and Kingfisher Airlines acquiring Deccan. Now, they are in deep losses and are running to the government for help.

Does for one moment anyone doubt the business acumen of the management of these companies? But then where did they falter? Was there anything wrong with their analysis? Yes. Their analysts were not doing analysis but they were forecasting. They were too optimistic on the future and the good times had made them overly confident of their knowledge and ability.

Another behavioural bias that has played an important role is anchoring. We had been so much anchored to the good times of the last four years that all the forecasts which were made were based on the past performance.

Hence, there was not sufficient adjustment in spite of the evidence that the world economy could be affected by a liquidity crisis. The first ripple of the sub-prime was felt in November 2007. However, over optimistic and overconfident investors did not pay any heed to the first signs of trouble. They were anchored to the thought that any crisis would blow away.

We had a four-year bull run and now it is foolish to expect that the bear market will end in four months. What is the road ahead for investors? Looking at the above problems how does an investor avoid them?

The most obvious solution is to stop relying on such pointless forecasts. There are plenty of common sense approaches that one can implement without the use of forecasts. Value investing is an idea whose time has come. In the current situation, there are eye popping values available at 6 to 10% dividend yield of good sustainable businesses run by credible management and having a healthy cash flow.

If one is very risk averse and wants to play safe, then equity investment is the best option. Have a two-year view. You don't buy life insurance and look at what will happen tomorrow.

Parag Parikh, Chairman, Parag Parikh Financial Advisory Services, specialises in behavioural finance. His column appears in the second week of every month