



INVESTING

# Star Behind Decisions

Our brains take shortcuts; most of our decisions are based on representativeness

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**O**ur brain takes short cuts in processing information. One such short cut is representativeness. We tend to make decisions based on stereotypes or similarity. Tata Steel comes out with good results and bumper profits. Investors start chasing companies in the steel sector expecting stellar performance. This decision is based on representativeness. Every company in the steel sector is representative of Tata Steel. Steel sector being representative of bumper profits becomes a fancy and investor favourite.

Sometimes, we wonder how everyone in the market is making money? A person who has made a loss is least likely to make it public due to the fear of being called a fool, loss of credibility, creditworthiness, business standing

. People will only talk about profits and never their losses. We start believing that stocks represent only profits and start chasing stocks and initial public offerings (IPOs) at any rate. Thus, we end up paying exuberantly high and fancy prices only to realise our mistake when the party ends. When the bear market sets in, as we saw in end 2008 to the first half of 2009, there is gloom all around, and with stock prices low investors suffer losses. Thus, stocks represent only losses and people avoid them. Due to this representativeness, investors find a stock more risky if no one is buying it and stock prices are low and less risky if the prices are high and everyone is buying it.

People talk about their profits, but never make their losses public for fear of being tagged a fool

Would you go to a barber to stitch your clothes or to a tailor to cut your hair? However, in the stockmarket, when a smart speaking gentleman sporting an Armani suit from a big bank visits you and gives you investment advice, you fall for it. Representative bias is at work. You are mistaking a salesman as an investment advisor. Bank is good if you require banking services, but definitely not for investment advice. Look at the track record of all these big banks who sold various confusing structured products, IPOs and portfolio management services. They have left the investors a lot poorer.

India is deficit in power. In a country like India an essential utility like power will always be price controlled. Power is definitely a growth sector, but that does not mean that investing in power companies at any price is a wise decision. Representative bias has made power stocks a fancy. Another representative bias is when investors mistake a good company as a good stock. A company may be fantastic, but buying its stock could be a mistake if one is paying an unduly high price for the underlying valuations. Infosys and Wipro are great companies, but if one made investment in these companies at the time of the tech boom, then one bought bad stocks of great companies.

Another representative bias where investors are prone to make inferior investment decisions is to mistake a corporation in an asset class to be as good as the asset class itself. Real estate as an asset class has paid handsome returns to any investor over a period of time. However, representative thinking makes investors believe that real estate companies or real estate mutual funds are also very good investments. Real estate, itself, and a real estate company are two very different things. A real estate company needs to fulfil certain criteria—the quality of management, the authenticity of the value of the land bank, transparency of the balance sheet, sustainable business model. That real estate transactions in India involve unaccounted cash component is a known fact. With this reality can any one judge the value of a real estate company? The past performance of real estate as an asset class should not be your yardstick to invest in a real estate company or a real estate mutual fund.

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