



INVESTING: BEHAVIOURAL FINANCE

The Heard Mentality

Consensus investing could be effective, but you need to get the timing right

PARAG PARIKH

There are two popular phrases in the lexicon of sociologists: "Man is not an island" and "Man is a social animal". Both these allude to our affinity to be part of a group, for it imparts a sense of security and well-being. This penchant for collectivism manifests itself in the form of 'consensus-based opinions' on various issues affecting us and the world.

Consensus can broadly be reached in two ways. You can browbeat your peers into veering over to your viewpoint, or cajole a large mass into believing in something through consistent and persuasive communication. The media excels in doing this.

Consensus-based actions are rampant in the investing world too

. Outsized moves in stocks and indices happen because a large mass of investors or traders suddenly begin believing in a too-good-to-miss idea. This leads to a virtual buying or selling panic, which can overwhelm all rational opinion. Often, the initial rationale behind the idea is sound. In fact, when it is originally floated, it is met with scepticism, which gives way to acceptance and then turns into mania.

A good example of this is the late 90s boom of technology stocks. In 1995, though there was a dawning realisation that India had an edge over other countries in developing software, the number of sceptics outnumbered the believers. However, by 1998 the ranks of believers had swelled manifold. The conviction was bolstered by the stellar earnings these companies were reporting and the fancy valuations of tech companies in the US. By late 1999, the mania had set in. 'Minor details' such as valuations were swept under the carpet and positive catalysts, such as the Y2K-related contracts, were blown out of proportion. All this ended painfully when these stocks tanked, with some losing up to 90 per cent of their capitalisation. Japan in the late 80s is another good example. Buoyed by its export-led economy, many supposedly savvy global investors blindly bought Japanese stocks despite their stratospheric valuations. Few foresaw that the ill-effects of rampant bank lending to Japanese real estate companies and unfavourable demographics would result in a prolonged lean economic path.

Consensus-based investing happens at all levels, not just among retail investors. The top 10 holdings in most MF portfolios will comprise various combinations of stocks comprising the Nifty even though there are over 2,500 stocks listed on the National Stock Exchange (NSE). That's because fund managers look for safety in numbers. After all, suffering a loss after purchasing the Nifty may not raise as many eyebrows as losing money by going overweight in a relatively unknown stock. Also, usually, people who question the prevailing consensus are branded 'Cassandras' and shouted down by the rest of the crowd. The 'endowment effect' is also at work here.

Among the consensus ideas going around currently, 'BRIC countries' and the 'dollar's demise' come to my mind. While early entrants into both these ideas have surely benefited, more nimbleness is now required to profit from these trends. The next couple of years will clear the air on whether these themes are enduring or not. It is conceivable that the BRIC countries will grow steadily and there is a slew of reasons why the greenback should lose its pre-eminence. My only contention is that opportunistic entrants into them today will find it difficult to make outsized returns as these are 'discovered' ideas. Finally, beware of the 'false consensus effect', where one tends to overestimate the degree of agreement that others are in with him. If you invest based on consensus, you better hone your market-timing skills. Or, you may end up holding onto an idea whose time is over.

Consensus-based investing happens at all levels, not just among ill-informed retail investors

[ABOUT US](#) | [CONTACT US](#) | [SUBSCRIBE](#) | [ADVERTISING RATES](#) | [COPYRIGHT & DISCLAIMER](#) | [COMMENTS POLICY](#)

