

## 'Brain takes a shortcut in processing information and doesn't process everything'

**H**euristic is the mental short cut the brain takes when processing information. It does not process the full information and this leads to biased or faulty decision making. Human beings are prone to follow certain rules of the thumb when making decisions. These decisions may not be rational, but since they are followed by all they become the standard. A very good example of this is when we give tips to the waiter who serves us in a restaurant. The acronym "TIPS" stands for "To Insure Prompt Service." If that were the case, tips should be given at the start of the meal. However, we follow the rule of the thumb and we always tip the waiter at the end of the meal.

There are different types of heuristics and we shall try to understand the Availability Heuristic, as it is very relevant in the stock markets. Investors, basing their decisions biased by the availability heuristic, stake huge amounts of money. We are subjected to huge amounts of information and what sticks in our mind is that information which we can readily recall. And this recall value comes with it being continuously and vividly displayed.

Let's take an example of an announcement by a company on its discovery of gas. The stock starts spurting as everyone starts buying on this news. Newspapers start flashing stories as to the size of such a discovery among other things. But let us analyse the situation

without becoming a prey to mental heuristics. Gas has been discovered, but it needs to be drilled and it takes a lot of time and money. What is the quality of the gas? How many wells would be needed for drilling? How much time will it take? How much money would be required and what are the plans to finance it? These are all very important and pertinent questions. In the meanwhile, the company will have to go through so many uncertainties, before the profits are reaped. However, analysts start predicting the future profitability and investors start chasing the stock. This is how mental heuristics work, when the brain takes a shortcut in processing information and does not process the full information and its implications. The tech boom was built on the same logic. Everyone talked of eyeballs and profitability of the company did not matter. Companies having more eyeballs commanded a better valuation than their profitable counterparts. All available information was on the eyeball theory and most of the investors believed in the emerging new economy. Availability Heuristic made investors make irrational decisions and lose money.

"Om Shanti Om" the latest bollywood hit is a case in point. If you saw the movie, you would be surprised that it is a big hit. Correct? Availability Heuristic is at play. All information on the movie that is fed to you is positive and vivid. And you wonder if something is wrong with your intellect.

*(The author, chairman, Parag Parikh Financial Advisory Services, specialises in behavioural finance. He will write every second week of the month on behavioural finance)*



“We are subjected to huge amounts of information and what sticks in our mind is that information which we can readily recall”