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INVESTING

Don't Follow The Herd

In this new column on behavioural finance, we take a look at initial public offers

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There are three birds on a tree and two decide to fly away, How many birds are still there on the tree?" Answer the question before you read on. My experience shows that 80 per cent of the respondents would answer one. The correct answer is three as two have only decided to fly away and not flown away yet. Why do we make such simple mistakes? It's because our brain takes shortcuts in processing information, it does not process the full information and, hence, we make such mistakes. In behavioural terms, these shortcuts are referred to as heuristics. We tend to follow the rule of the thumb, or follow the herd. One such investing anomaly is the mad rush for initial public offers (IPOs)

. At present, we are witnessing a bullish stock market and, I believe, that this is an appropriate topic in current times. My aim is to help investors process information rationally and, thus, make well-informed decisions.

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Why do IPOs come in bull and not in bear markets? Bull markets make investors overconfident of the future, inducing them to pay high prices for stocks. The managers of companies see this as an opportunity to unlock the value of their holdings as the investors are willing to pay a much higher price for stocks than their underlying worth. In bear markets, investors shy away from stocks and are not willing to pay any fancy prices. It doesn't make sense for the management to come up with an IPO as they would be selling their holdings at a substantial discount. One needs to invest when the prices are low and not when they are high. However, since IPOs come in bull markets when prices are high, it benefits the management rather than investors. Investors will never get a bargain as IPOs don't come in bear markets.

Is it right to call it an IPO? Are you getting an opportunity to be an initial investor at the initial offer price? Today's IPOs are available at the market price. If you have to pay the market price, then there is a huge choice for you. There are over 6,000 stocks listed and available at market price. Then, why this euphoria about IPOs? It's absurd to assume that the IPOs are offered to you cheap.

Should you believe the investment banker of the IPO? The company pays the investment banker to get the maximum price for the stocks offered in the IPO. Investors read the research reports, attend the investor conference and listen to the talks of the same investment bankers who are there to offload stocks of the company for whom they work. They are the selling agents, however investors mistake them as investment advisors and professionals.

Is the grey market premium the right anchor? Is there any authenticity in the premium quoted? Has the past not shown that the grey market premium is not reflected on listing in most of the cases? The role of the grey market premium is to get the issue subscribed. Who benefits? Does it require a genius to know that it is manipulated? Despite this, investors fall prey to such manipulations. Remember the euphoria the grey market premium created for the close-ended fund of Morgan Stanley before its launch over a decade back. This only showed the fickle-minded behaviour of investors—their willingness to pay a premium on a close-ended fund about to start.

Investors have taken a fancy to the infrastructure, power and real estate sectors in the present bullish conditions. Stocks of such companies have shown considerable appreciation and, hence, companies in these sectors are readying themselves to launch IPOs. The net is cast wide, decide if you want to bite the bait. By chasing a fancy, you end up paying a fancy price that results in losses when the fancy ends.

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