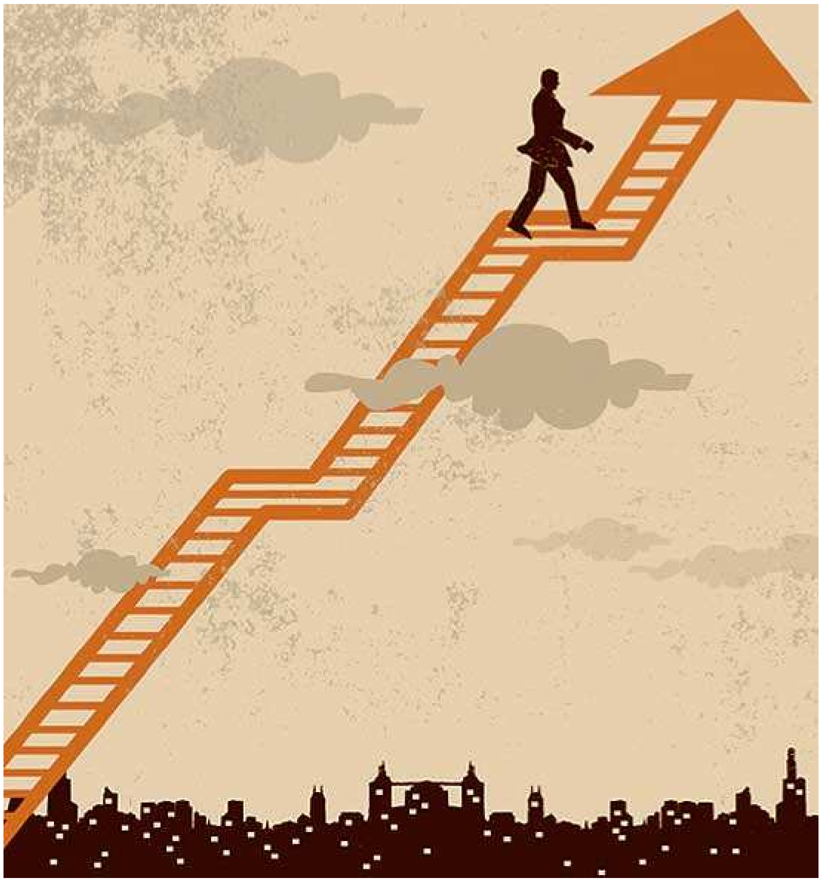

INVESTING: BEHAVIOURAL FINANCE

Feet Firmly On Ground

Amid sustained market euphoria, it's important to check overconfidence

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In the stockmarket, making profits through any means is the goal of most players. Speculation, day-trading and arbitrage are some tools commonly used by the majority in this quest. And those who make the maximum profits are lionised by all and sundry.

We have been witnessing a sustained increase in stock prices during the past year or so, with the market looking determined to march ever upward. All the doomsayers who revelled in 2008 and early-2009 have been silenced. In fact, today you will find people citing a dozen reasons as to why India is in a sweet spot and why its stockmarkets deserve to trade at a premium. The financial media, too, regularly highlights lay investors who have made a fortune just by timing their purchases right.

In this environment, we must guard ourselves against the onset of overconfidence, as it could result in some of these perils:

The belief that good times are here to last. In investing, we often extrapolate the current circumstances into eternity

. Hence, there is the danger of falling into the trap of believing that stock prices will never correct downwards. Such feelings gain traction when we only receive positive feedback from people.

Expert opinion often tracks the consensus. Plus, they usually have a vested interest in remaining bullish

Ignoring the voice of sanity. When we are experiencing the exhilaration of massive paper profits, we love to believe those who will bolster our belief in a perpetual bull market rather than those who are supposedly intent on puncturing our happiness.

Suspension of disbelief. During bear markets, we may dismiss financial projections by even the most credible companies. Even reasonable base-case projections elicit raised eyebrows as we are unduly influenced by the pessimism around us. As a result, we ignore compelling valuations and miss great opportunities to buy good stocks cheap.

The reverse holds true during exuberant times. We tend to believe all earnings projections, however fanciful they may be. This is especially true of companies that we already own (the **endowment effect**).

Here's how to guard ourselves against these traps: **Cognisance of market cycles**. Just as optimists believe that what goes down must come up, realists believe that what goes up must come down. While one may quibble about the optimum degree of such ups and downs, in the stockmarket, our wariness should increase in direct proportion to the trajectory of the rise in stock prices. Stretched valuations may continue for longer than expected, but that alone is no excuse for holding on to overvalued stocks.

Do not believe in "The Greater Fool Theory". Often, we know that stocks are overvalued but our overconfidence tempts us into believing that we can bail out of them before the stampede begins. Remember, intellect and fleet-footedness need not go hand in hand.

Companies don't always know the best. The rosiest forecasts may be made at the most inopportune of moments by companies that get carried away during bullish times. Besides, no management wants to accept irrational market exuberance. Many companies cynically exploit such times to raise more capital than required, thereby reducing the return on equity (RoE) for years.

Do not believe experts blindly. Expert opinion often clusters around the broad consensus. Besides, experts, whether on the Buy or Sell Side, usually have a vested interest in remaining bullish at all times.

Keep your ear to the ground. Often, alertness to subtle changes in the investing environment will not only help you guard against overconfidence, but also strengthen your own self-belief.
To have a better understanding of "Overconfidence", visit www.ppfas.com and under "Understanding Behavioral Biases" go to "Shortcuts To Failure".

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