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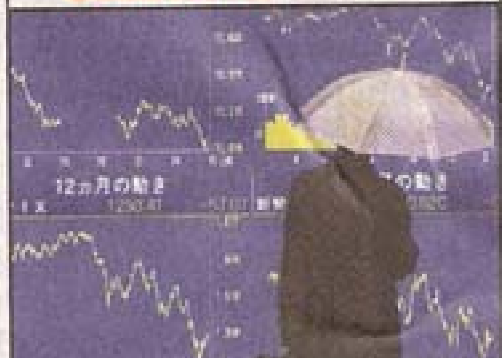
Investors unable to control greed and fear result in huge volatility of the markets

The markets are currently being swayed between the emotions of greed and fear. When the markets are in a bull phase, everyone wants to buy faster than the neighbour. One finds stocks under buy circuit for days together, just becoming expensive by the day. Investors are distressed when they are not able to buy. Then comes a big correction and investors wonder if the party is over. Now, they want to sell faster than their neighbour. The stocks nose dive and we have an exactly the opposite situation. Stocks go on hitting lower circuits everyday and start losing value. Investors are distressed as they are not able to sell.

How does one explain this behaviour? The same stock under bullish conditions was a favourite of all. The same stock loses flavour just because the markets are bearish. Are these people investing? Definitely no. This is speculating or, in other words, gambling. They are following the greater fool theory. Buy what others are buying, for there would be some other greater fool to buy it from you. You don't mind being a fool as long as there is another greater fool to bail you out.

SEEKING COVER



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This is one of the reasons for the huge volatility of the markets. Investors are unable to control their greed and fear. Two planes crash into the World Trade Center and the next day the world stops travelling. Airlines go empty. The fear is totally unjustified as planes do not crash into buildings everyday. This was one off event and people started giving undue importance to it. In fact, the next day was probably the safest day to travel by air. Behavioural economists call this the Saliency Effect. People lay too much importance on a one off event and extrapolate too much in to the future. They overreact to such events, assuming their repetitions, while evidence suggests the opposite. The chances of recurring are very minimal. However, fear starts dominating and people are prone to act irrationally. This is what is happening in the current situation. If the markets fall on a certain day, fear dominates and investors are reluctant to invest. Once the market bounces up, greed starts dominating and investors rush to buy. These are just salient events taking place on certain days and in no way should it affect one's decision making if one is an investor. Such times come and go. One needs to have a long-term view on investments.

Similar instances abound in the world of investing. An exceptional quarter earnings announcement by a company is extrapolated too far in to the future and the stock starts rising. This one off event of a quarter doing exceptionally well is assumed to set the trend for all the coming quarters and people start buying. Conversely, investors would punish a stock on just one quarter's dismissal performance. So is the fickle minded behaviour of investors.

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