Of cheater rallies and rebounds

When investors are loss-averse, how do they behave?

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Last week, I explained how fear was still evident in the markets and that was the reason that the markets would go up.

One would see volatility with huge falls on certain days. But do not mistake that to be a bearish trend.

I would term these as cheater's rallies. The markets would again bounce back with a vengeance. The reason is simple: the sentiment is upbeat due to huge inflows and at the same time there is fear that the markets will go down.

These are both very conflicting sentiments faced by investors. During such times investors tend to suffer from loss aversion: that is the fear of making losses. It has been proved that the pain of a loss is three times more than the pleasure of an equal amount of gain.

Over time, loss becomes terrifying and pleasure becomes boring. When investors are loss-averse, how do they behave? They tend to play it safe and thus they sell of the winners too fast and hold on to the losers.

This is what is happening in the markets. Investors have got off their winning investments too fast and when they see those stocks hitting the roof they have regret aversion for having missed the bus. In such a situation they are always waiting for buying opportunities and hoping that the markets will go down.

So, at every decline huge buying comes in from these investors and the market again rebounds.

Not many are really able to take advantage of such falls and thus we have more of unsatisfied hungry investors waiting to get in to stocks. This itself is the reason that the markets are still going up.

One of the main arguments of behavioural economists is that people are more loss averse rather than risk averse. If people were risk averse then they would not enter the stock markets. But it is not the risk, which they are scared of, but it is the fear of making losses that really haunts them. It is because of this that they tend to be over cautious but at the same time they still believe that they should not miss any opportunities. This is how people sway between emotions of greed and fear. Then again you have the available heuristic in play. What is Availability heuristic?

Wanting more

Investors have sold their winning investments early and when they see those stocks soaring, they rue their luck

At every decline, we have these investors trying to chance their luck again

All the information around us, which is good for the markets, is positive.

The quarterly earnings, the FII inflows, the huge collections by mutual funds, analysts forecasts, the government's positive attitude, the media hype etc. All these positives far out weigh the negatives like the fiscal deficit, the soaring oil prices, the Left's opposition to the reforms etc.

Not that these are not valid factors but they do not get reported in as much frequency and force as the positives. So we are bombarded with only positive news and we only start believing in them.

Trend is your best friend: Looking at all the factors discussed above it is evident that investor sentiment is upbeat. With interest rates so low there are no other worthwhile investment opportunities.

Moreover when we see the Sensex going up and hear stories of how stock investments have made people wealthy we get attracted towards stocks. This is the current trend.

Those who could not see the trend early enough or those who went against the trend have lost. When markets are driven by herd psychology it makes sense to be with the trend.

Now if you do not have the nerves of steel to face the volatility and the losses, which may arise if the trend changes, be away from the stock markets. This current trend will also change when the sentiments change. When that will happen no one can say, not even me.

Change it will. But it may be within a week, a month, a year or two years. Nobody knows. When you are not able to know what to do go with the trend.

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