PARAG PARIKH

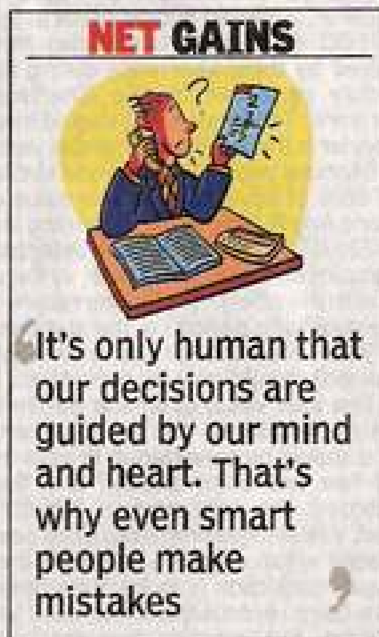
Sentiments sometimes change even when the fundamentals are the same

THE MARKETS were shocked when the BSE index fell by more than 600 points on August 1. There was fear all round, and analysts and the media said the markets were overvalued. They were trying to find reasons after the event. A few weeks earlier, when the index touched 15,000: everyone said the economy was growing over 9%, the corporate profits were great, and the markets were attractive. Some even predicted when the index would touch 18,000.

Market PE seemed cheap. Now, with a fall of over 500 points, isn't the market even cheaper? And shouldn't investors come and buy at these attractive rates, sending the markets back up? The same people who found the market attractive when it was going up found it unattractive when it started going down. Yet, the fundamentals hadn't changed: the economy was still cruising, and corporate profits were still strong.

What had changed, though, were sentiments. Greed was replaced by fear. The reason for such of behaviour is that most people do not have a firm grasp of investment concepts and fundamentals. They imitate others in a bid to make easy money. The conventional economic wisdom is that markets are efficient and people make rational decisions. But new research supports Behavioural Economic Theory, which says that markets are inefficient in the short run and people do not make rational decisions to maximise profits. The reason is simple: we human beings have a mind *and* a heart, and our decisions are guided by both. A lavish birthday or wedding celebration is certainly not a profit-maximising act by a rational human being; it's an emotional decision influenced by one's emotions. Emotions are why even intelligent people make financial blunders.

NET GAINS



'It's only human that our decisions are guided by our mind and heart. That's why even smart people make mistakes'

In the stock markets, there are no geniuses. Could anyone have predicted August 1? The fall had less to do with Indian fundamentals than with fear that global markets were sinking. Investors are irrational: last year, when oil rose to $65 a barrel, the markets plunged. Today, it hardly seems to bother anyone that oil is $75 a barrel.

Finance as we understand it is: 1+1=2. If it were that easy, markets would be boring. What excites people about markets is their inability to understand it. Markets consist of the actions of millions who behave in unique irrational ways because of greed and fear. And so we have Behavioural Finance, where anthropology meets economics, and psychology intersects with finance.

In stock markets, Behavioral Finance explains why we hold on to stocks that are crashing, foolishly sell stocks that are rising, pay for ridiculously overvalued stocks, jump in late and buy stocks at the peak of a rally just before the price declines, take desperate risks and gamble when our stocks descend, avoid the reasonable risk of buying promising stocks unless profit is guaranteed.

(Parag Parikh, chairman, Parag Parikh Financial Advisory Services, specialises in behavioural finance. His column will appear in the second week of every month.)