When certain sectors are hot, companies are tempted to access the capital market

Investors have the tendency to rely on heuristics to make decisions. A heuristic is a rule of thumb. Investors often make judgments and predictions by relying on heuristics that make use of analogues and stereotypes. This underlying principle is known as representativeness. The extent to which an object or an idea fits a stereotype, investor decisions is based on how representative that object or idea is for the class to which it belongs. Its relevance in the market cannot be ignored. Investment decisions based on representative biases abound. And if we understand the same, we can identify mispriced opportunities in the markets.

When a leader in a particular industry reports exceptional performance, signifying a change of fortunes, its stock starts rising. However, investors also start chasing representative stocks in the same industry. It is assumed that since the sector has improved, all the stocks in the sector will do well. For example, when the fortunes of the steel sector changes and Tata Steel came out with impressive results, even the laggards in the steel sector attract more interest from the investors. In such a situation, the unscrupulous promoters take advantage of the representative heuristic and try to position their companies with what is the latest fad in the markets. How many times we hear today about certain stocks going up because they are sitting on huge land, which is going to be developed, or companies getting in to the infrastructure sector.

SAFE STEPS

Being a part of the herd is better than being alone. Being a representative of the popular fad and a fancy gives the illusion of safety

When certain sectors are hot, it becomes a strong temptation for companies to access the capital market, as the investor interest is high at that moment. We have seen a host of real estate companies cashing in on the present real estate fancy. "Reliance Power to get in to power equipment business," reported the newspapers. Dominant players in the power equipment field are companies like L&T, BHEL and Siemens, who are the favourites of the stock markets and commanding hefty valuations. Representative thinking would make investors compare Reliance Power with these companies and find the public issue more attractive.

Why investors subject themselves to representativeness heuristic? Firstly, it is the human tendency to come to judgments fast. In doing so, they neglect to process all the information. Secondly, representativeness gives the solace of making the right decision, as there is an anchor available. Lastly, it is the greed that makes investors rely on representativeness. Being a part of the herd is better than being alone. Being a representative of the popular fad and a fancy gives the illusion of safety.

Representative heuristic could lead investors to take faulty investment decisions by choosing investments or mutual funds—based on the past performance, based on stock market movements, or through market gossip.

(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.)