

A nifty primer on the world of behavioural economics

An investor is not rational and at best is "satisficing" himself

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Conventional economics has always maintained and still maintains, despite the evidence to the contrary, that markets are efficient and human beings are rational.

"Markets are efficient" in simple terms means that the price of a security in a market at any given point of time incorporates all the available information. Given this any further change in the price of the

security will be random and so investors cannot profit from it.

Conventional economics maintains that human beings are rational and will always act to maximise their gains.

Parag Parikh's book *Stocks to Riches* essentially tries to explain this dichotomy. It's a primer on a relatively new area in economics, called behavioural economics.

Surprisingly this field of economics was brought to the fore by two Israeli non economists, Daniel Kahenman and Amol Tversky. Kahenman went on to win a Nobel Prize in Economics. Tversky if he was alive, people say, would have shared it with him.

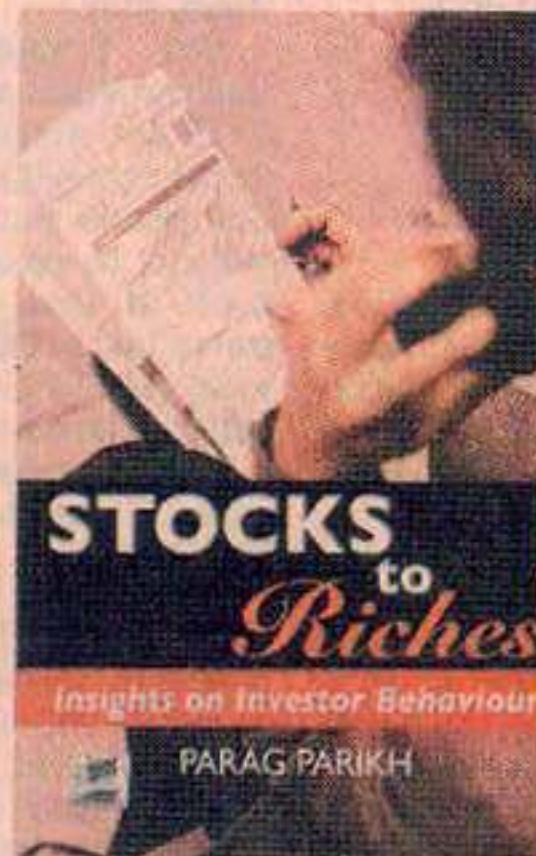
Sample these two situations: 1. "You have paid Rs 500 for a movie ticket. When you

reach the ticket window you find you have lost the ticket. Would you buy a new ticket? or would you prefer to go back?" (Pg 62).

2. "You go to the theatre to watch a movie. When you reach the ticket window you find that you have lost Rs 500 out of the Rs 2000 you were carrying. Would you still buy the ticket?" (Pg 62)

Most people who take this test, answer no in the first case and yes in the second. Now both the situations are basically the same and entail a loss of Rs 500. This behaviour of individuals is referred to as mental accounting.

Richard Thaller, a pioneer of behavioural economics, coined the term mental accounting, and it is defined as



From loss aversion to satisficing, Parakh Parikh explains how to go about it

"the inclination to categorise and treat money differently, depending on where it comes from, where it is kept and how it is spent".

Investors, during a bull run, tend to behave similarly. Once they have got a certain return on their investments, they tend to plough all their returns (which is in a separate mental account) back into the market.

When such money goes into fundamentally weak stocks, investment essentially boils down to speculation. And if they happen to lose the money they tend to rationalise by telling themselves that they just lost the initial amount that they invested, when in reality that is really not the case.

Further, investors are ready to take more risks when

it comes to bringing down their losses and hold on to what they know is a losing proposition.

But when it comes to selling stocks which have been going up, investors tend to do that too soon.

How many times have you heard in the last year about an investor wailing about the fact that he shouldn't have sold so soon. This fallacy of the investor is known as "loss aversion".

Parikh explains these and other such terms which clearly show that an investor is not rational and at best is "satisficing" (a merger of satisfy and suffice). He stops when he gets a near satisfactory solution instead of going in for an optimal one.