

The quest for reasons

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Human beings are problem solvers by nature. We often want to get to the root of the problem in order to find out solutions. No doubt this is a positive trait. It has been instrumental in the resolution of several seemingly intractable problems. The corollary to this is that we usually do not like it when things happen without any apparent explanation or rationale to back it up.



While the world of science operates on a “cause and effect” basis, the world of investing may not follow the same rationale. Even then, as investors we often seek rational explanations to seemingly irrational events that happen periodically in stock markets. Lay investors look to “market experts” to underscore the reasons behind specific market moves. We take solace in sentences containing the word “because” as it consoles our mind

that we have found the cause behind the effect. Consequently, we often accord disproportionate importance to certain events.

Here are a few examples:

Fact: The BSE Sensex has risen nearly seven times in seven years (from 3,000 in 2003 to 21,000 in 2010).

Reasoning: This is “because” foreign investors are attracted to the India growth story and pumped in large amounts of money.

In saying so, many fail to acknowledge that the past seven years have been great for emerging markets in general and the Indian market is just one of the boats being lifted by this rising tide. Maybe it has risen more than some others, but it is by no means the only one. In fact, cynics are confounded by this rise, believing that the Sensex has risen “despite” many negatives such as the lack of concrete policy reforms, unequal economic growth, etc.

Fact: The S&P 500 Index has given a one-year return of 10.7% (as on January 10, 2011).

Reasoning: This is a counter-intuitive development. After all, the US is struggling with high unemployment and tepid growth. So how did this happen? Well, the market experts have a ready answer. It is “because” of the Federal Reserve’s policy of Quantitative Easing. This has led to torrents of liquidity, some of which is finding its way into US stocks.

Yes. It is true that a lot of money is being printed in the US. However, it is also true that export earnings comprise around 30 per cent of the profits of the companies in the index and the falling value of the US dollar has bolstered the earnings and the valuation of these stocks. Which reason should get more importance?

Now here’s a tricky one. While the S&P 500 has risen 10.70 per cent, the BSE Sensex is up by only 9.60 per cent in the same period. How has this happened when one economy is growing at 8 per cent and the other around 2 per cent. I would love to know the reasons behind this. Our desire to seek reasons makes us dissect the slightest wiggles in stocks and indices, even if there may be none. That is why if you tell someone that the market fell by 500 points today, they will immediately want to know the reason why it did so. The stock market is an amalgam of various emotions and stocks could spike up or plunge, based purely on psychology. To seek reasons for every move can be frustrating for those who indulge in it although there is no dearth of participants (including the financial media) attempting to do so.

Also, let us for one moment assume that you know all the reasons. Does it mean that you can predict the future any better than the one who is ignorant? I would suggest that as an investor you could spend your time more fruitfully in analysing the business prospects of a company before investing. At least this is within your control. The fetish for wanting to know the reason for everything could lead you nowhere. Besides, once you have done your homework, you can take better advantage of price movements. After all, fortune favours the prepared mind.

The basic intent of my article is to communicate that one need not spend too much time dwelling on the reasons for everything in the stock market. While a complex host of factors may be responsible, it may be equally possible that no concrete factor may be behind a move. Besides, even if you know the reason, it is always in hindsight. There is no correlation between knowing the reason and success in investing.

Warren Buffett has reportedly said, "If past history was all there was to the game, the richest people would be librarians". I am not privy to the reason why he said this. But I wholeheartedly agree with it.

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