Learn the basics of saving and investing

Earning Curve

BEHAVIOURAL FINANCE

'It seemed so obvious'

That's hindsight bias in action

In 1991, researchers Martin Bolt and John Brink asked students to predict how the US Senate would vote on the confirmation of a Supreme Court nominee. Prior to the vote, 58% of the participants predicted that the nominee would be confirmed. When the same group was polled again, he had been confirmed; 78% of the participants claimed this is what they had predicted. Experiments like these have been repeated before and after major events; it is well-established that humans have a tendency to reconstruct events in their memory as they have occurred. This common behavioural trait is known as 'hindsight bias'. If you find yourself making any of these statements, you may be suffering from hindsight bias. "I knew India was going to lose." "That's just common sense."

Many now conveniently claim that the signs of the real-estate bubble of 2008 or the technology bubble of the late 1990s were obvious.

How is this bias harmful for investing? If you are unaware of this bias, your mind will perceive events as being more predictable than they really are. This leads to overconfidence. Investors can convince themselves that they had predicted past events accurately; their automatic assumption will be that they can predict future events also. On the basis of such overconfidence, they often make poor investment decisions that cost them dearly. ■

STOCK SHASTRA #7

Selling Your Stock

Three signs that tell you when to sell

To earn high returns at minimal risk, the right price to buy a stock is at/below 50% discount to its maximum retail price (MRP). We need to sell, once it crosses the MRP (or the right value of the stock). Since no one can time the market, knowing when to sell is one of the toughest decisions. While taking a decision to sell your stock, you may encounter these three scenarios.

1) Well above MRP – If the stock price is well above its current MRP, that is **20% above MRP,** consider selling the stock, as the market is overvaluing the stock irrationally, above its earnings capacity. If the market has overvalued the company right now, there are chances that it will correct in the future. In such a case, it would be a great opportunity to sell the stock, book profits and buy it later when it is available at a good discount.

2) Just above MRP – If the current stock price is just above the stock's current MRP (0%-20%), you could consider selling it, if:

a. The company ceases to be wonderful: If the company's MRP is stagnating due to reduction in expectations of earnings capacity and it is not a short-term problem, most likely, the company has ceased to be wonderful. This will usually show up in the form of poor financial performance.

b. There is a better opportunity available: If you have found a better company where the probability of growth and returns is higher and it is available at an attractive discount.

c. You are in requirement of funds: If you are in need of funds, it is always better to sell off a stock that has crossed its right value (MRP), rather than selling one which has scope for appreciation in stock price.

3) The company has ceased to be wonderful, before reaching its MRP – If there has been a sudden change in circumstances, or you have received new information which changes your opinion about the company, consider selling the stock; even though its current price may not have touched its MRP.

(Condensed from the Stock Shastra series – an educational initiative of www.MoneyWorks4me.com)

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Stocks @ MRP