Learn the basics of saving and investing

Earning Curve

BEHAVIOURAL FINANCE

Disprove Your Own Beliefs!

How confirmation bias leads to skewed decision making

Gaurav, an avid investor, is genuinely convinced about the future of a certain company and decides to buy its stock on the basis of that belief. Soon, some negative reports about the company start appearing. It turns out that the company is not in good financial shape. But he refuses to take this information at face value. He then comes across another article a few days later that makes a strong case in favour of the company, in line with his own opinion about it. Gaurav tells himself that he was right all along and decides to buy more of the stock. He has just fallen prey to a behavioural stumbling block called 'confirmation bias'.

This is an offshoot of two other maladies covered in the previous issues—overconfidence and anchoring. Investors have a tendency to hunt for specific information that lends support to their beliefs, totally disregarding any other evidence. In other words, it is a type of selective thinking.

Very often, investors assign the highest importance to a piece of information that confirms their opinion and downplays conflicting information. For instance, if we've purchased a mutual fund concentrated in infrastructure stocks, we are likely to over-emphasise positive information about the sector and discount whatever negative news we hear about infrastructure companies and their outlook.

George Soros is successful because he actively seeks a different viewpoint

There are numerous studies, which have identified this behavioural trait. In one experiment, psychologist J Edward Russo asked his students to choose between two restaurants based on the comparison of their menus. First, he asked his students to compare the two eateries considering the whole menu. In this case, the group was equally split between the two choices. However, when Russo asked the students to make their choice dish by dish, 84% of students opted for the restaurant which got their vote in the first instance. An Ohio State study in 2009 showed people spend 36% more time reading an essay if it aligns with their opinions. By choosing to ignore strong evidence that refutes their own opinion, investors run the risk of missing the big picture. The smartest investors actually go out and seek contrary opinion even if it means having to swallow one's pride!

INCOME-TAX

Taxing Issue

The 'trader' *versus* 'investor' debate continues to flummox shareholder-taxpayers

Paying taxes involves a host of issues that can make life miserable for the honest taxpayer. A common bone of contention between taxpayers and tax authorities is regarding the classification of income from 'sale of shares'. This debate has been raging for years and refuses to reach its logical conclusion. It is a major headache for most taxpayers. On the one hand, tax authorities seek to treat such income as 'business income' while, on the other, taxpayers demand that it should be classified under 'capital gains'. In case such transactions are classified as 'business income', the person does not get the benefit of zero tax on long-term capital gains. The problem is compounded by the fact that different tax officers have differing views on this subject. While one officer may view your investment activity in its actual vein; another may be intent on treating it as 'business income', no matter what evidence you place

before him. In the unfortunate event that your tax returns is picked up for scrutiny by the income-tax officer (ITO), you will have to hope and pray that it is not the latter type who is investigating your case. Last year, the Mumbai bench of the income-tax appellate tribunal gave two contrasting decisions on this issue—one treating the gain as 'capital gains' and the other treating it as 'business income'. What factors does an ITO look at while examining your share-market transactions? ITOs usually take into consideration the period of holding, the frequency of transactions, the motive of the transactions (to be examined on facts) and the source of funds (whether own or borrowed). However, none of these factors, in isolation, can be taken

in determining the nature of the transaction. Investors are most likely to land in trouble if they have borrowed funds for investment. Also, selling off shares in a short period and doing many such transactions in a year will make one's case even more difficult.

Although a CBDT (Central Board of Direct Taxes) circular has laid down guidelines to help officers distinguish between traders and investors, this still remains a grey area as taxpayers may be asked to prove why capital gains should not be considered as business income. Trying to prove it to be so can be a harrowing task for anyone. ■

STOCK SHASTRA #5

Look for trustworthy management

A wonderful business worth investing in is one which has an excellent financial track record and sustainable competitive advantage. Another equally important criterion is that the business should have respectable and trustworthy management. Strong financials and competitive advantage will amount to nothing if the management is known for giving false information, is arrogant with minority shareholders, indulges in insider-trading, pays too much attention to itself, etc.

Here are a few pointers that can help you assess the worthiness of a management.

1) Aligned with Your Interests: Check whether the management's interests are aligned with the interests of the shareholders. For this, check for the following clues:

• ***Vision and Plan:*** Does the management have a vision that appeals to you and has a plan to implement it?

• ***Compensation of Top Management:*** If the management is paying obscene amounts of monies to itself even when the company's profits suffer, it is better to stay away from such a management.

• ***Waning Interest in the Company:*** Is promoters' interest in the company declining? For this, check whether the promoters are reducing their shareholding a bit too often; the CEO and top management are selling/exercising their stock options periodically; and the

promoters are pledging their shares. If the promoters are indulging in any of these activities, they obviously have only short-term interest in the company. It is better to stay away from such a management.

• ***Buyback of Shares:*** If the company buys back its shares at a time when the market is undervaluing its stock price, it usually reflects the management's confidence in the growth of the company.

2) Transparency: Does the management share the actual threats and concerns the company is facing and admit to the mistakes it might have made?

3) Dividend Payment: A good manager retains a part of/entire profit only when he thinks he is able to earn a handsome return on it, otherwise he prefers to pay dividend.

You can get information on these points from a company's annual report; especially the Directors' Report, Chairman's Speech & Management Discussion and Analysis.

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