THIRD WAVE SOLUTIONS

Of Mental Accounts

Cognitive Biases Series

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Behavioral Finance is a study of the systematic errors made by market participants due to psychological biases. It explains, amongst other things, why investors are often reluctant to sell shares (or other investments) if doing so would result in "*booking a loss*". One thing it doesn't talk about though, is the belief by each participant that he is not subject to these psychological biases. Unfortunately, that is very far from the truth. In this series, we hope to make you conscious of the common biases and how to overcome them, especially when it comes to investment decisions. We begin with one of the most well-known biases in the investing world - ***Loss Aversion*** - and its lesser known cousin – ***The House Money Effect.***

Of Mental Accounts

Almost any Indian investor with an investing track record of a few years, especially if it dates before January of 2008, has likely seen at least some of his or her investments lose 50% or more of their value (Reliance Power anyone?). Worse, those shares probably still form part of his portfolio – and for the wrong reasons. Others, probably with longer track records, might have a few shares whose value has doubled (or more) since their purchase and are a source of joy to the investor. However, these too, the investor is unwilling to part with – even if the price reflects no great possibility of future growth. Both these phenomena are manifestations of the same underlying mental framework – something called "***Mental Accounts".***

A *mental account* is a mental construct that the mind uses to keep track of gains and losses. For instance, it is a common tendency amongst investors to keep track of gains and losses on individual securities (while completely ignoring the gain or loss on the overall portfolio!). What's more, they base their decisions to buy, hold or sell on whether they are making a profit or a loss on the share and whether they have made or lost money on the share in the past. Most readers are probably shaking their heads in agreement. This is as tragic as it is common.

The Investors' Dilemma

Mental accounting leads to sub-optimal decisions in a variety of circumstances. In the case of stocks, two particular instances are common. The first is the tendency to hold on to stocks that have lost considerable value since purchase. Several instances spring to mind from recent years. For instance, investors in shares of Suzlon are probably amongst the ones who have fared most badly. As late as June 2009, shares of Suzlon traded at Rs. 120. Since then, there have been persistent issues relating to slowing sales growth and huge debt-service burden, etc. The share price too has been on a slow decline. *(Figure 1)*

At each point, investors expected that the fall would be arrested and the price would rise again. The price spent considerable time at around the Rs. 50 mark where most investors could have taken their exits. Those who'd bought the shares at the highest prices were least likely to do so, though, not wanting to "book their losses". Without considering the actual circumstances of the company and its

Figure 1 - Share Price of Suzlon (*Courtesy: Google Finance*)

uncertain future, most held on to the shares – not because of some conviction about the change in fortunes, but because of an aversion to booking losses. The side-effect, however, has been an even further loss with the share now trading close to Rs. 20. The question now is, should they book their losses and get out now?

Consider the reverse condition – rarer – but one that certainly does occur. For instance, the shares of Vikas WSP (a guar gum and guar gum derivatives company) were trading at Rs. 10 at the end of 2011 (having fallen from grace due to some financial restatements, etc). However, a small section of the market, bullish on guar gum, took positions in the company. Right from the start of 2012, with clarification of the financials, the share began a sharp upward rally and by mid April had racked up impressive returns of 600%. While the stock was now much riskier at Rs. 70 a share, those who had purchased the share at Rs. 10 were quite complacent. In any case, the logic went, "My purchase price is ~Rs. 10-20, so there is no way we can lose money now. I might as well hold on to the company." Should they have booked their profits?

Buy/Sell Decisions to be Forward Looking

The answer to the questions at the end of the preceding two paragraphs is – *it depends*. At any point of time, the question should not be whether or not to book ones profits/losses. The question should be – what is the outlook for the company (and more importantly, the share price) *going forward*. In the case of Vikas WSP above, the question an investor should ask himself is – do I see the stock price going up significantly from here or would I rather just keep my Rs. 70 thank-you-very-much.

Similarly, in the case of Suzlon, the choice should be made on whether the investor considers a real possibility that the share price performance will be better than any alternative investment options he may have for that money. It should not matter that he has lost considerable money on that investment (or bet?). As we saw in the case of Suzlon, the decision to not sell at Rs. 50 because considerable losses had already been borne led to a further decline in value of 60%!

As normal human beings with all our frailties, we are all subject to the forces of cognitive biases. However, by accepting that we may be making suboptimal decisions due to such biases and by understanding the nature of these biases, the hope is that we can overcome them and become better investors – and therefore wealthier than we might otherwise be.