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Do you invest rationally?

Behavioral economics is not really a new branch of the dismal science. Even before the awarding of the Nobel prize in economics to psychologist Daniel Kahneman in 2002, there was already an understanding of how emotions play a part in economics. The famous "Law of diminishing marginal utility" was established by economist H. Gossen in 1854. It states that "as consumption increases, the marginal utility for each additional unit decreases." The twenty-first Patek Philippe watch acquired does not feel as special as the first one. This law does not apply to cash.

More contemporary observers like economist Steven Levitt and journalist Stephen Dubner (Freakonomics) now delve on the psychological drivers of economic decisions—like why parents bequeath more to their grown-up children who visit them regularly.

Even investors relying mainly on quantifiable data like price/earnings ratios, multiple of book value, internal rate of return of an acquisition look for other behavioral indicators like management moves or volume of transactions, as these subjective factors drive the investment decision.

How do you pick stocks?

Professional analysts look for "themes". These are usually the flavor of the month or quarter. If gold and oil are moving up, which they sometimes do, commodities become a theme. The government-announced program of "Build, Build, Build" caught the fancy of stock pickers for a while. What about inward remittances that keep rising? Does this trend herald higher consumption levels, with the theme shifting to property stocks or food and retail because of the higher purchasing power of the recipients?
The stock pickers also hunt for undervalued stocks with a high upside. The dive in the price and the now underpriced level may be a result of an overreaction to a one-time loss. Undervaluation is expressed in terms of times over book or the classic price-earnings ratio, compared to peer companies.

When do you buy? After picking a stock, it is a matter of buying it. Do you buy at the opening price the next day? Some factors like yesterday's trade whether closing at asked or bid price and what volumes are on either side determine how next day's opening price will be like. This is also influenced by some late news like the performance of the Dow index or the release of GDP growth rate.

But one must remember that for the price of the stock, the market is never wrong, as it follows the "efficient market hypothesis". The efficiency of the market assumes that all the news, good and bad, is already factored into the price.

Impatient investors can put their investible funds in one go. Is averaging up or down over a number of days or weeks more rational? Since the market is volatile, going in at one price is akin to betting everything in one draw of the cards. Note the casino reference here. The game of chance and risk management provides lessons applicable to both casino and the market. Some say there is really no difference, except that in the market players are not served free drinks.

When do you sell?

It's all paper profits or losses until you sell? This is the most important decision for the investor. Is it rational to sell as a stock's price is rising and you are making a good return, and do you also then hold on to the dogs with the hope of the latter making a comeback? Sometimes, selling at a loss for a stock that is already barking like a dog can be the most sensible move. It prevents even bigger losses.

The irrational investor may keep checking the price of a stock he has already sold last week at a hefty profit. Okay, he just wants to know how he would feel if he held on to it for one more week. He experiences seller's remorse as the balloon continues to rise. He's thinking of how much more profit he could have made. Maybe, he could have bought another watch. Anyway, when the stock finally does its eventual dive, he is elated...and then proceeds to get back to buy the stock again. This story seldom has a happy ending.

It is good to remember the advice of John Maynard Keynes who was both an economist and a market player—the market can stay irrational longer than you can stay solvent. This is a hard lesson to learn, even for the rational investor.

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