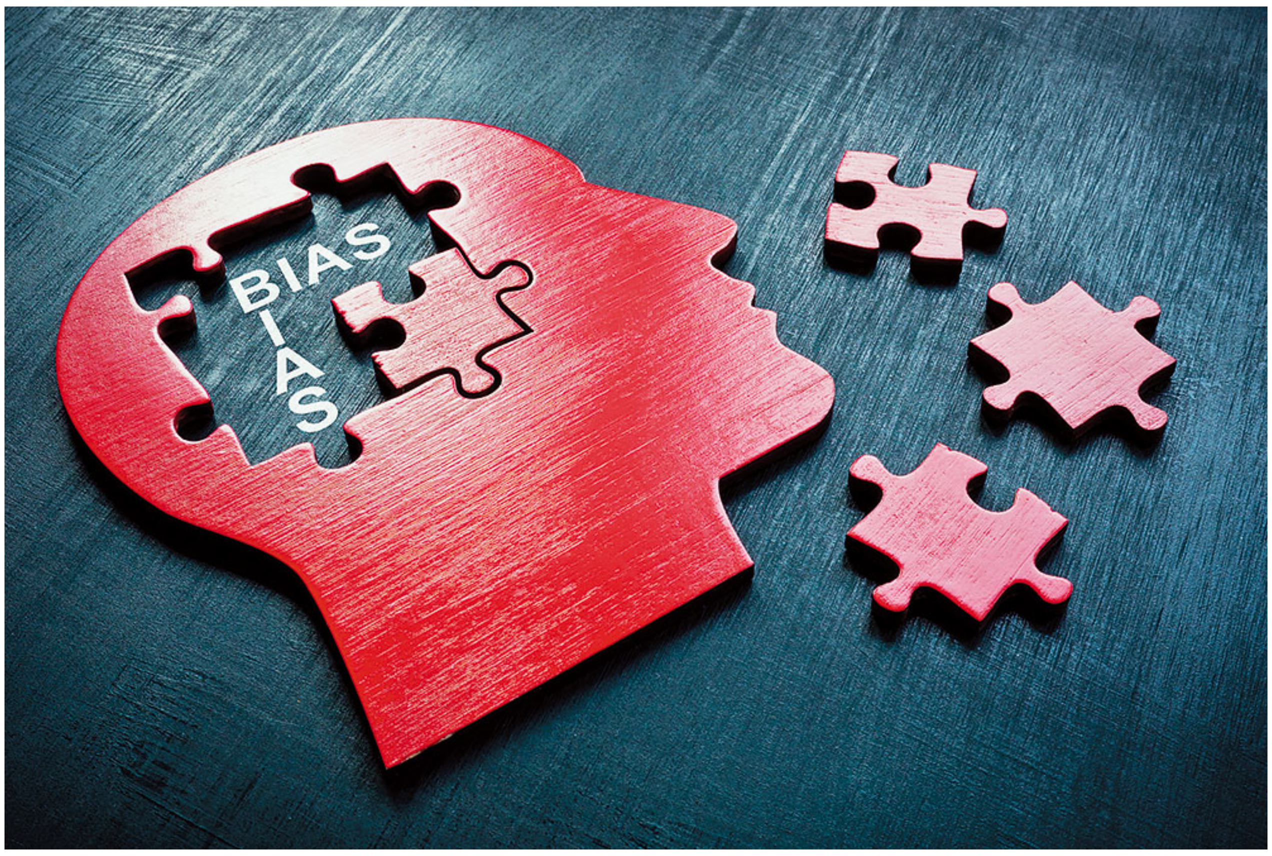
Outlook MONEY

Stay Aware Of Your Recency Bias



Stay Aware Of Your Recency Bias

Larissa Fernand - 06 February 2024

Giving in to recency bias related to an event like the Union Budget is akin to speculating. Asking the right questions before biting the bullet is very important

If there is something you should know about investment behaviour it is this one single fact that it is the same across every market in the world. Similar patterns are witnessed across races and nationalities, and it has been played out across centuries.

That is so because human nature is a constant. Beneath all the superficial characteristics of humans, we are the same, a trait also observed by Voltaire: “When it comes to money, everyone is of the same religion”.

When it comes to the stock market, you should know this. Fear sells and excitement buys. And every single mania in history has revolved around this. Be it the Tulip Mania (1637), the Mississippi Bubble (1720) or the South Sea Bubble (1720). More recently, we had the Dot-com Boom and the Bitcoin Bubble. Abundance of intelligence, or the lack of it, is completely irrelevant here. I remember reading with great amusement a research note that stated, “Issac Newton did not just taste of the (South Sea) Bubble’s madness but drank deeply of it.”

Today, people want to drink the public sector undertaking (PSU) mania. Some of the headlines that I encounter are:

- Railway stocks rally before the Budget announcement.
- Railway stocks took a beating.
- PSU stocks’ rally continues.
- Pre-Budget sentiment stocks to buy.
- Multi-bagger PSU stocks.

Please note, I am writing this before the announcement of the Union Budget 2024. By the time you read this, the situation may be completely different, which will only prove my point.

This article is not about the Budget. Neither is it about whether or not you should invest in PSU stocks or railway stocks. It is about how we get carried away by events. The event could be a trade war, geo-political conflict, or tapering (the incremental reversal of a central bank's quantitative easing strategy). This time, it is the Union Budget.

The financial media milks the situation and gives clickbait headlines and people get carried away in the frenzy. None of us know what is going to be presented in the Budget. Moreover, with elections around the corner, don't forget this is just an Interim Budget. To add to it, the rising bull market tide is taking everything higher. Thus, finding a good bargain is getting increasingly difficult.

PSU Stocks And Recency Bias

Recency bias comes into play where we give more weight to recent events. So we extrapolate the current rally into the future and forget that something inevitable called the bear market also exists. Basically, we assume that recent performance equals future performance. We project from the present into the future. We look at the latest returns and estimate probabilities based on them. Whatever has happened most recently, you believe will most likely continue to happen.

That explains why everyone is super confident and over optimistic. This is also true of individual stocks as well as indices, or what we like to call "the market". So how do we combat recency bias?

A look at the S&P BSE PSU index even gives me a feeling of having missed the bus. It was at 8,272 on January 3, 2022, and it has now crossed 16,700. If you had got your timing impeccably right, then June 2022 would have been a good time to pick up some stocks. But then in hindsight, we are all brilliant, are we not? Ironically, at that time, most investors wrote PSUs off.

In 2017, I remember a lot of excitement surrounding PSU stocks as Union Finance Minister Arun Jaitley announced the Bharat 22 exchange-traded funds (ETFs) to boost the government's disinvestment plans. At that time, the investment was frowned upon by so many, but now it is being praised for its 1-year return that is over 60 per cent. Investors are fickle. Present them with current returns and all the past is swept under the carpet.

So before you bite the PSU bullet, can you convincingly answer these two questions?

- Why did you not invest in PSU stocks in 2017 and 2022?
- Why do you believe that PSU stocks will keep rising and make for a good investment now?

Can you see the point I am making? Investors who are currently getting swayed never looked at PSU stocks when they were at lower levels. They want them now that they are riding high, in the hope that they will go even higher. Legendary investor Bob Farrell explains this behaviour. "The longer a trend persists, the more people look at the trend as permanent. That's why investors buy the most stocks at the peak in prices, and the least at the troughs." That's recency bias at play.

I remember discussing PSUs with Devina Mehra of First Global last year. Her observation is so pertinent to this discussion: "The PSU index crossed its 2008 high in 2023. During this time, the index flirted with its high in 2010, 2014 and 2017, but never crossed it. In fact, there were multiple 50 per cent drawdowns, too." That is a wait of 15 years! Would you have been happy holding on to an investment for that long?

If you were buying based on a solid thesis, don't you think you would have already purchased them? I am assuming that you are buying because you honestly believe in them as a long-term investment. If you do not have a solid thesis, but want to buy after its stupendous rise, you are probably doing so based on a lot of emotion, and hope. Both very dangerous.

Let’s say you are buying purely as an opportunistic bet. Well, I hate to burst your bubble, but tactical bets are not as ideal as you think.

- Do you have an exit strategy in place for investments?
- What is the price at which you will take the money and walk away?
- Are you investing only because of potential upcoming dividends?
- If yes, do you plan to sell it immediately after the dividends are credited into your account?
- After that where will you park the money you receive?
- Have you calculated the tax implications?
- Are you investing because of an anticipated fresh investment announcement by the government for railway infrastructure development in the upcoming Interim Budget? Are you buying based on the expansion of the Vande Bharat trains over the next five years?
- If the above thesis does not play out, can you afford to lose this money?

Recency bias often makes us speculators, and we don’t even realise it. If your decisions are solely guided by price, then you are a speculator, which is perfectly fine as long as you know what you are doing. In that case, do have an articulate exit strategy in place, and be mentally prepared to take a hit.

Larissa Fernand writes on the mindset of investors and their relationship with money