

The ‘hold’ rating for securities: what explains why it even exists?

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The retail investor continues to chase the racy segment of the market disproportionately.

SUMMARY

It owes its existence to an 'endowment bias' that makes people place an irrational price premium on what they own. Investors get even more attached to their investments than households objects. But smart investing means overcoming irrationality.

Even an absolute novice in the stock market understands what a ‘buy’ or ‘sell’ rating given by a research firm means. But ‘hold’? That’s not quite as intuitive, is it? The real question is: Is it even rational? Think about it—if a security is not worth buying today, why is it worth holding?

The whole construct of a ‘hold’ rating is to hide from us the [fact](#) that we are being irrational by putting a covert [premium](#) on something precisely because we are already holding it.

This irrationality arises out of something called the endowment bias. Anything that belongs to us automatically has higher [value](#) for us. Surprisingly, this holds true even for mundane objects.

A seminal study on the ‘endowment effect’ was carried out at Cornell University by Richard Thaler, Daniel Kahneman and Jack Knetsch. (Look up Experimental Tests of the Endowment Effect and the Coase Theorem).

It carried out a simple experiment. Half the students were given coffee mugs with the university logo on them and half were not. A few days later, they were asked the price—that is, what they would be willing to buy or sell that mug for.

Logically, whether or not they had those mugs should not have made a difference to their estimated price. But the reality was very different. The students who had got the mugs were not willing to sell them for less than \$5.25 on average, while those without mugs wanted to buy them for \$2.25-\$2.75.

Thousands of years ago, Aristotle wrote: “For most things are differently valued by those who have them and by those who wish to get them: what belongs to us, and what we give away, always seems very precious to us.”

Recently, multiple experiments have validated this tendency. Our willingness to pay for something is far lower than the price we are willing to accept to give up the same object, even when there is no cause for attachment, or even if the item was only obtained minutes ago.

This attachment or tendency to overvalue what we own only becomes stronger when we have inherited an object or owned it for a long time. Neuroscience also has explanations for it.

Our attachment to our investments is even higher than what it is for everyday objects. For one, they are more closely aligned with our well-being. Also, investing in a stock or other asset means that we have analysed the options and made a deliberate choice. Now we don’t want to change our mind because it would mean accepting that our earlier choice was incorrect.

As a result, we are likely to be even more invested mentally (pun intended) in a stock that we own than in our other possessions.

Let us say for a particular stock you might rationally analyse that a price-to-earnings (PE) multiple of 18-20 times was justifiable.

But if you hold that stock, you may feel that a PE ratio of 25 or 30 is also justified. You may continue to hold that stock even when [it](#) goes beyond your rational valuation threshold.

Endowment bias is the single reason why a ‘hold’ rating exists at all in the lexicon of market analysts.

You may even kid yourself that you are holding onto this investment because you do not want to incur unnecessary transaction costs, but the transaction cost of a switch is usually negligible compared with the potential loss of holding on to the wrong investment or the potential profit that was not realized by not switching to the right asset or security.

The comfort factor with something familiar could keep one holding on to stocks too, or it could be decision paralysis that leaves your portfolio unchanged for long periods because you want an irrational premium to sell something you hold.

This is visible in the real estate market also, where people hold on to a benchmark price and wait years to get it—an economically irrational ‘hold’ decision. If they had sold the house all those years ago and put the money even in a fixed deposit, they would have been better off.

Viewers typically ask ‘experts’ on television questions like: “I bought this stock X years ago at Y price. What should I do with it now?” Other than the name of the stock, all other information in this question is irrelevant. The market has zero interest in the viewer’s purchase price. It makes no material difference whatsoever. But that is never said.

Understand that you do not have to make your money back through the same investment. Your bank balance does not care where the money has come from.

The only real way to get over this bias is with a zero-base portfolio approach—to think about how you would deploy your money if you had the equivalent of all those shares in cash today. Do this at least once and twice a year.

Do not worry about how you can bring yourself to sell Hindustan Unilever shares bought by your parents, or fear offloading a stock that has made you a ton of money, such as HDFC Bank or Apple, for example.

Preferably, do this with another set of eyes—your life partner, your financial advisor or someone who has no stake in proving that the initial decision to invest was correct.

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