mint

Incentives drive each and every participant in all capital markets

Devina Mehra | 20 November 2025

Incentives work for every player in the market, not just the big ones.

SUMMARY

Investors must remember that behind almost every ‘buy’ call or stock recommendation lies a motive. This applies across the equity market, whether or not we know the specific incentives of participants. But then, everyone is guided by self-interest, including retail investors and speculators.

Charlie Munger famously said, ‘Show me the incentives and I’ll show you the outcome’. After my last column , ‘The Great IPO Rush: Never go by the big names that have invested’, where I explained why big institutional names invest in some crazily-priced initial public offerings (IPOs), people asked me about other incentive-driven behaviour by financial market participants.

Let us start with stocks being recommended as ‘buy’-rated by large stock broking and research firms and how much credence you should give such recommendations. The big names may lack either the competence or the integrity (or both) to give the right advice.

Surprised? They may not be capable of doing a good job of analysis or may not put enough effort in it. Alternatively, they may be pushing some agenda.

If that were not the case, you could blindly buy those stocks in the public market that have the highest number of 'buy' ratings at any point. In most cases, you will find this strategy will lead to your portfolio underperforming.

This is because large players have their own institutional imperatives where they are trying to keep either their internal or external consumers (meaning their bosses or clients) happy by saying what they want to hear.

Thus, securities firms will not say anything negative or have 'sell' ratings on companies from which they hope to get investment banking business. Also, they will not have 'sell' ratings on stocks that are major holdings of the funds that are their clients.

The net result: Every study of Wall Street has shown that of all stock ratings by research houses, only between 1% and 7% are marked 'sell' at any point. All the rest are 'buy' or 'hold.' So, over 90% of research reports recommend that you buy or hold that stock! This itself illustrates how skewed the game is.

The proportion is unlikely to be different in the Indian market. This alone should tell you the futility of relying on such ratings and what the results will be if you make investment decisions based on them.

The other issue: Research analysts tend to move in herds. It is comfortable and safe to hold the same view as the consensus, rather than try to form an independent opinion. A very good example of this is Amazon in the year 2001. At the time, First Global was perhaps the only firm with a 'buy' rating on Amazon when it was trading at less than $15 (75 cents adjusted for a stock split).

Remarkably, much of Wall Street was positive on Amazon for the few years leading up to this period, and then all of them turned negative together, most of them even predicting bankruptcy for the company. If they had bothered to focus on the financials, they would have seen that for the first time in its history, Amazon was making huge cash flows and was no longer at bankruptcy risk.

Unfortunately, the incentives in this business are such that a research analyst is safer if she writes what everyone else is saying rather than go out on a limb and take the risk of being wrong.

Then there are investment bankers. How much should you rely on the brand names of the managers of an IPO? The truth is that investment bankers are paid bonuses only for the number of deals done and the amount of funds raised/fees earned. Their evaluation is only on their position in the league tables. They do not even make a pretence of evaluating the business. Their stated objective is to maximize the issue price for the company.

No investment banker is ever evaluated on how the stock does after the IPO. Let that sink in.

There is also another incentive at work before and after an IPO. Any investor, institutional included, who has invested in a company either at the venture capital or IPO stage has a vested interest in keeping the price high, as a fall in price hurts their own net asset value. That could be a possible reason for their investing in subsequent rounds or buying stock in the secondary market. I have already written about the incentives for asset management companies to launch thematic funds near the peak of that theme's cycle.

All of this is not to say that each and every player in each category behaves in this way; only that incentives will come into play and drive behaviour in most cases.

Now we come to the most interesting part: Who is to blame for price bubbles? After a financial bubble bursts anywhere in the world, we all look for villains, with the blame falling mostly on large institutional players like banks and brokers, or their employees.

What somehow remains sacred or sacrosanct are markets and the 'common' speculator. They are never blamed, but maybe they should be.

Whether it is small-firm IPOs, the non-fungible token (NFT) frenzy, Tulip Mania or any of the past madnesses in markets, all have been as much about 'common' people thinking that they had found a way to quickly multiply their money as about their being misled.

It was willing suspension of disbelief. This is different from real mis-selling. In many cases, there is little justification for people to invest a large chunk of their savings in the 'flavour of the time,' except sheer greed.

Incentives work for every player in the market, not just the big ones.

The author is chairperson, managing director and founder of First Global and author of 'Money, Myths and Mantras: The Ultimate Investment Guide'. Her X handle is @devinamehra