# Beware The Soothsayers

*Herd behaviour has made markets volatile but nimble pundits always ride with the winner*

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The last decade has seen quite a saga in the world of financial markets, starting with a prolonged credit boom that was followed by a sudden and largely unanticipated bust. The attendant pain and the blame game that ensued, with fingers being pointed at virtually every player on the financial stage, added another act to this tragedy of errors. While the dramatis personae – banks, regulators and governments – may have finally salvaged some of their battered reputations, the financial world has become a riskier, more volatile place.

For those of us who have been bewildered by the twists and turns of this unfolding drama, there are some new lessons to be learnt about the efficiency of markets, the psychology of herds and the consequent irrationality of market behaviour and prices.

The first thing that one needs to accept is that there have been profound changes in patterns of market behaviour, influenced by quick flow of information through 24-hour news channels, a profusion of news wires, and the rise of a professional fund manager who is willing to trade on every piece of information in a desperate bid to outdo his or her competitor. The result, fundamentally, is that new information has been very quickly built into asset prices, making short-term profits very difficult. This resulted in professional fund managers lagging the market. Statistical data show that small investors would probably have been better off investing in the stock market index both in terms of diversifying their portfolio and their returns.

Combine this with profound predictions of the new oracles – analysts, fund managers, TV experts – add a dash of programme trading and you have a very potent cocktail. The upshot is that everybody trades on the same information, the same analysis and the very same 'tip' picked up in cocktail party discussions. This leads to the 'bhed chaal' or bandwagon effect that manifests in two things. The phenomenon of everyone and their uncle either bidding an asset price up or down en masse hugely exaggerates the volatility in prices. It also leads to periods of irrational exuberance followed by phases of irrational despair.

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To cut a long story short, what this herd behaviour does is vitiate the basic principles that Economics 101 teaches. When prices rise, demand actually rises in response instead of decreasing. Everyone is human and likes to get rich and so jumps on the bandwagon. Rationality, that should drive prices back to fair values, goes on a picnic. The guys transacting on the fact rather than the rumour end up losing their own or their clients' shirts or pants and are overrun by a tsunami triggered by the hooves of the herd. An asset bubble then emerges.

Bhaag Milkha aandhi aayi....

Helping this herd behaviour is one of the best soap operas being played out by our analysts, portfolio managers and business channels. The dialogue is familiar – 'risk on, risk off, high beta, QE taper, liquidity, Bric trick, inflation, GDP, employment stats, flight to safety, oil prices, geopolitics' etc etc.

Caveat emptor. Take this all with a generous pinch of salt. All this jargon might appear to have a touch of infallibility but actually doesn't. These are essentially convenient terms to give 'profound' views, their brilliance driven by 20:20 hindsight with (and this is the important bit) the safety valve of changing one's view and advice at will. The funny thing about these ubiquitous pundits is their complete lack of accountability – you can change daily your opinion without fear, favour or remorse.

But spare a thought about the investor or fund manager who fell prey to this fickle punditry – the poor soul who sold Indian equities when the rupee was 67 to the dollar and stock prices were low priced, leading to a near riot in the market as FIIs rode the doomsday bandwagon on the assumption that Ben Bernanke was all set to wind up QE3. Who compensates them now that the market is at a three-year high and rupee at 61?

Who else gets the short end of this stick? It is the poor policymaker who needs to explain his actions and policy in this highly irrational environment or even worse the central bank or government that is forced to act to influence the market, causing asset bubbles or unpredictable reactions.

Unfortunately, the oracle industry is here to stay. Otherwise, where will the soap operas, crises and last but not the least, fat analyst bonuses come from? But what should you do as a sensible investor? Revert to common sense and be safe. You, however, run the risk of being miserable in the short term as you think of lost opportunity (which almost no one caught). The show goes on with how you could have made money if you had 'divya drishti' instead of 20:20 hindsight and remorse. The choice is yours.

In the long run asset prices will revert to the mean (fundamentals) and are, therefore, far more predictable. There are no precise answers other than that you are better safe than sorry. If you must invest in equity go for the long term through the stock index or follow Warren Buffett and do not invest when you have missed the bus, i.e., when stocks are expensive. Most importantly, be content with this decision.

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