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Buy the Rumors; Sell the News

"I believe that market prices are always wrong in the sense that they present a biased view of the future. But distortion works in both directions: not only do market participants operate with a bias, but their bias can also influence the course of events."

– **George Soros**

People try to anticipate the outcomes of these events and also the impact of the same on the stock prices

During late 2013 and early 2014, India was experiencing what was termed as the "Modi Wave". In September 2013, BJP announced Narendra Modi as their Prime Ministerial candidate for the General (Union) Elections to be held in April and May of 2014. Economic and Business slowdown and corruption scandals were the main issues taken up by the party to attack the incumbent UPA government. Presenting his track record and role in the development of the State of Gujarat, Narendra Modi offered promises of a comprehensive economic development package to revive GDP growth and per capita incomes. The election was held in 9 phases from April 7, 2014 to May 12, 2014. 66% of the 814mn eligible voters, turned up at the polling booths to cast their ballot. The results were declared on May 16, 2014 and BJP created history. The BJP, along with its allies under the National Democratic Alliance, won with a thumping majority. It was after a gap of 30 years that any Indian political party won a clear majority in the General elections!

Stability at the Central Government level and positive vibes about economic growth fueled hopes of better times ahead for the stock markets. So, after the announcement of this huge positive development, how much did the Indian benchmarks gain that day? Answer – 1%! The markets opened higher and quickly saw profit booking by investors. For the next 10 trading sessions (Two weeks) the widely tracked indices of Sensex and Nifty 50 didn't even touch the

May 16 intraday high. For most of the two weeks, the daily candlestick (technical indicator) pattern showed 'black', which means the market could not maintain its high opening level. And the closing level for the month of May was almost the same as the closing level of May 16th. What happened?

When events unfold as expected i.e. the consensus predicted the outcome correctly, the markets do not behave as anticipated

THE ANSWER WAS DOCUMENTED IN THE YEAR 1688

There are many important events that have a preannounced date declared days or months or even years before the actual event. National election, Union Budget, Monetary Policy, Fiscal Stimulus announcements, important Economic Data releases etc. create a buzz among investors and in the media. On a company specific level, these events can be in the form of earnings announcement, product launches etc. People try to anticipate the outcomes of these events and also the impact of the same on the stock prices. Recently, a lot of investors are talking about the upcoming US election for example, and what impact a Biden win, or a Trump win can have on the markets. However, when events unfold as expected i.e. the consensus predicted the outcome correctly, the markets do not behave as anticipated. Hence comes the old adage among the stock market traders, "Buy on rumors, sell on news".

The expectation of an event creates a much deeper impression upon the exchange than the event itself. When large dividends or rich imports are expected, shares will rise in price; but if the expectation becomes a reality, the shares often fall

Believe it or not, despite the absence of so many meetings/events in the seventeenth century, Joseph De La Vega had written about this behavior of markets in his book 'Confusion de Confusiones' (A fantastic read) in 1688. De La Vega was a Spanish man of varied interests. He was a merchant in diamonds, financial expert, moral philosopher and poet, residing in 17th century Amsterdam. In the book he writes, "The expectation of an event creates a much deeper impression upon the exchange than the event itself. When large dividends or rich imports are expected, shares will rise in price; but if the expectation becomes a reality, the shares often fall".

He calls this behavior of stock prices quite natural and explains it logically using the observed behavioral characteristics of the both types of investors, the Bulls and the Bears. Whenever there is an event where the consensus is expecting a positive outcome, the Bears would generally refrain from getting in the way. The Bulls become quite

optimistic with the state of affairs, and the prospects of gains will drive them to buy more. They become overconfident and any small negative development on the way to the event doesn't deter them from their path.

"But as soon as the ships arrive or the dividends are declared, the sellers take new courage. They calculate that for some months the purchasers — the bulls — will not be able to expect very propitious [new] events", says De La Vega. With nothing to look forward to for some time, the Bulls either take profits or stop their additional purchases. The Bears start selling based on the excesses that were created on the way to the event. "...and therefore, no wonder that the shares fall, because they are abandoned by the one side and are attacked by the other".

NEW BEHAVIORAL FINANCE RESEARCH ON THIS PHENOMENON

As human beings, we have a unique ability to simulate experiences in our heads before we experience it in the real world. This simulation sometimes also brings in a bias called the 'Impact bias'

Advances in Neuroscience and Psychology have put new light on studying financial decision making under uncertainty. According to Daniel Gilbert, an American Social Psychologist and writer, while the size of the human brain increased almost threefold in the two million years of evolution, it has also gained new structures. It gained a new part called the 'Prefrontal Cortex', which acts as an experience simulator. As human beings, we have a unique ability to simulate experiences in our heads before we experience it in the real world. This simulation sometimes also brings in a bias called the 'Impact bias'. It is the tendency to overestimate the intensity or the duration of future emotions and states of feeling.

Now, as we know, when an event is expected, people would tend to forecast the outcome and its impact on stock prices. If the outcome is likely to be positive, we simulate the happiness of profiting from it. We have read in the earlier article about Dopamine (read here) which induces us to trade whenever we come across an opportunity. If the event is important and its outcomes are vivid and easily imaginable, it starts getting a lot of attention. Everyone is talking about it and analyzing it. A positive narrative builds up (read here) and leads to herding (read here).

Anticipation of reward generates a positive affect state. Positive affect motivates both increased risk-taking and increased purchasing behaviors

A fascinating research paper by Richard Peterson, highlights that "Anticipation of reward generates a positive affect state. Positive affect motivates both increased risk-taking and increased purchasing behaviors." Rising prices reinforce the trend and investors downplay the risks. As we move towards the event, 'Myopic Discounting' comes into effect. It refers to the tendency to prefer near term rewards over longer term. "As the anticipated potential reward approaches in time, investors' positive affect is increasingly aroused", says Peterson.

By the time, the event date is reached, much of the upside from the outcome, the consensus is expecting, gets exhausted. New and inexperienced investors may still continue to flock in at this stage. Once the event is done with and the outcome is as per expectations, not matter how good, the trend starts reversing. We had discussed in the earlier article that if the reward doesn't increase, Dopamine is not generated in the neurons. With nothing to look forward to immediately, the profit booking sets in (Disposition Effect); risk taking moves to risk aversion. Price fall confirms the change in trend and starts reinforcing downward move.

SHOULD WE CHANGE THE WAY WE LOOK AT IMPORTANT EVENTS?

According the Richard Peterson, the "Buy on Rumors, Sell on News" pattern works when these conditions are observed:

1. Potential rewards from the event are easily imagined and there is wide public recognition of the potential reward (if everyone is doing the obvious)
2. There is minimal dissemination of information about the event's risks and minimal investor conditioning to or experience with the event risks (investors are either risk seeking or don't understand the risk)
3. Acceleration of upwards price movement as the event approaches and above average security trading volume (Upward momentum = high expectations)

'Myopic Discounting' comes into effect. It refers to the tendency to prefer near term rewards over longer term

Coming back to the example we started with, about the India elections in 2014, the Indian market indices had moved up 20% in the six

months to the elections (From mid-November). The Modi wave was spreading and his popularity increasing. The exit polls had indicated a BJP led government, though only one exit poll survey had the high number of seats that were actually won. All the signs indicated that a win was discounted in the market prices.

Handling such a market anomaly caused by investor behavior requires an intelligent investor to assess what outcome is already priced in and what value is left on the table.

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Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).