

Priceless: The Hidden Value of Psychology



Author: William Poundstone

Book Summary

Research and economic studies have indicated that markets are, actually, not perfectly competitive and Priceless – The Hidden Value of Psychology by William Poundstone offers an excellent discourse on this theory. The price of a commodity or a stock or an item is influenced by a variety of principles, which are the result of different experiments. An important principle is the law of diminishing returns which states that most human beings do not feel happiness in direct proportion to the money they gain. For instance, it is not necessary that if you find Rs. 500 lying on the ground, you would be five times as happy as you would have been if you were to find Rs. 100. Indeed, the important aspect in pricing is not the absolute price but the relative price, as explained beautifully by Poundstone.

William Poundstone is known for being the bestselling author of over a dozen nonfiction books offering readers insights on a number of topics, such as Fortune's Formula, Gaming the Vote, and Priceless. He has been nominated for the Pulitzer Prize for his books Labyrinths of Reason and The Recursive Universe. Poundstone is known for his incisive writing style and the ability to get to the core of the issue in simple and comprehensive words.

Key takeaways

- It would be nice if instead of purely focusing on the cost of projects you instead focus on the output and value of the project.
- Within an organization, certain people, for example, procurement, are responsible for ensuring that the cost stays minimal. On the other hand, marketers are made responsible for driving up the company's underlying value, causing a contrast.
- Most people are really good at finding the price of things. However, only few know the actual value of the items on sale.
- The hidden psychology of value clearly shows how most people react to the most persuasive and important aspect of a product, i.e., its price
- While prices are important to figuring out the value of things, there is quite a bit of illusion surrounding the price tag and it is up to you to figure out the intrinsic value and match it to an equitable price.
- Behavioural economics shows how people are limited in their thoughts because of underlying bias. However, to calculate and arrive at the right price, these biases need to be controlled.
- Humans can be, and are, routinely influenced to look at certain prices and find them more attractive than the competition's products.

Have you ever wondered what prompts you to purchase things which are deemed costly? What is the distinction between cost, price, and value and how is behavioural economics a part of how we make these decisions? People usually think that markets are competitive and rational. This means that you would generally assume that there is a proper alignment between the price and actual cost of a product, in addition to its underlying value. However, if you look closely you will see that often many products are priced at a level which is much higher than its actual cost while its true value is much lower than the quoted price. A common assumption that we often make is that the demand-supply equation is well matched and thus the price in the market is fair. When we make this assumption, we tend to forget that because of behavioural economics, companies are often able to charge us a price which is much higher than the actual value of the product. On a daily basis, we come across a variety of price tags with companies now offering anything and everything as a commodity. However, before purchasing something, it is important for you to assess its true value, as, otherwise, you would end up spending a high amount of money for something with limited value.

Two proponents of security

If you are a value investor, or someone who is interested in the concept, you would surely have heard of the terms price and value. These are two proponents which define each security and, in the words of the legendary value investor Warren Buffett, price is what you pay for attaining an object while value is what you get after purchasing the object. When there is a disconnect between price and value, it can be looked at as an investing opportunity, and this is the principle behind value investing. When you notice that a company with a strong underlying value is trading at a price which is lower than its inherent value, you buy and hold the stock, making it a part of your value investing portfolio. By doing this you can sell stocks that are overvalued and buy stocks that seem undervalued.

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Concept of fair value

By now, you would most likely understand the difference between price and value. But what exactly is the concept of fair value? Fair value is the value at which a security would trade, if the market comprised only of intelligent and rational traders who are not swayed by emotion or bias. Fair value acts as the investor's anchor when the security is caught up in price fluctuations. If you are planning to buy or sell a security, do not follow the trend or go with the flow, consider the fair value of the security and build positions only after you have evaluated this figure. Indeed, even the market may not really know the fair value of a security, as it is made up of all types of traders. In fact, to further clarify this aspect we can say, "Graham caricatured the price psychology of investors in 'Mr. Market'. He's a well-meaning simpleton who shows up at your door every weekday offering to buy or sell stock. [...] Mr. Market really doesn't know what stocks are worth. The clever investor can profit from this." Indeed, the market is simple and the average market participant might not have the right understanding or knowledge about the price and value of securities. Thus, as a value investor, it is important for you to not get carried away by market prices. Instead, you should try to make efforts to understand the true value of an investment before making a decision to invest.

Experimental studies of market prices

Famous American economist Colin Camerer has conducted experimental studies on market prices and his research helps us view a super-simplified stock market. In his experiments, Camerer gave participants some money and two virtual shares which offered dividends worth 24 cents, every five minutes. The experiment lasted 75 minutes and participants had to use the stocks to participate in the market. Accordingly, the stocks were worth \$3.60 at the outset, with its value dropping every five minutes, in line with the dividend payouts. The experiment showed that the stocks began trading at \$3, quickly rose to \$3.60, and remained at this level till almost one hour. Towards the fag end of the experiment, prices began to crash as participants realised that the prices were too high, considering the falling value. However, they held on to the stocks till almost the end, as they wanted to gain more dividend payouts and believed that someone else would buy the stocks, at inflated prices, before the end of the simulated market. And, this is exactly how the actual market works. According to the popular Greater Fool Theory, investors purchase securities based on illogical thoughts and hopes around the potential rise in security prices (not value) and believe that they can, later, sell it to a greater fool. This model does not function on logic or rationale and is, actually, based on excessive or irrational confidence. When a number of investors exhibit this irrational confidence, the market goes for a toss. It is in such scenarios that logical value investors can stand to make strong profits and build meaningful positions.

Tenets to follow

The understanding that the market is flawed, inherently, helps investors build sensible positions. The emotional spectrum, beginning at panic and ending at euphoria, offers investors a number of opportunities to make value purchases and sales. However, given that most market participants are yet to develop rational thinking skills, investors who have strong logic and rationale behind their decisions can stand to make excellent trades. Contrarian investors who have the courage to swim against the flow, and hold on to their logic-dictated decisions, will emerge on top during such scenarios. Indeed, investors should only purchase securities when there is an alignment between price and value, or when price is sharply lower than the underlying value, as this offers a comfortable safety margin.

There is no doubting the fact that human beings are emotional at best and foolish at worst. However, if you can simply control your inherent biases and manage your fears, you can end up investing from a place of logic and reasoning. This will help you overcome behavioural biases and potentially generate profits in the stock market. Once you analyse and understand behavioural economics, you can take value investing steps and decisions which will put you in league with the investment legends. After all, the market is a simpleton and can be leveraged for profit as long as you don't fall into the trap of overconfidence or irrational exuberance.

Everything said and done, overcoming biases is no easy task, especially when it comes to dealing with money or making investment decisions. Which is why it is often recommended to rely on the expertise of investment professionals for your financial decision making. This is where an investment vehicle like a mutual fund can really add value to your financial journey. Before we understand how mutual fund investments can help you overcome bias and find true value, let's first understand mutual funds. These are investment vehicles that pool investor money and then invest it in a variety of investment instruments

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based on scheme mandate or strategy. They are professionally managed and fairly liquid and give you the benefit of diversification. In addition to these benefits, mutual funds have the added advantage of helping you overcome behavioural biases. There are two ways by which this is done. One, you can invest in mutual funds via the Systematic Investment Plan (SIP) route. This allows you to invest a fixed amount of money in a mutual fund scheme of your choice and at time intervals that suit you best. Further, you can start an SIP with as low as Rs. 500. This means that as long as you continue with your SIP, you will be able to participate in market ups and downs and mitigate the impact of biases. Two, you can also choose to invest in Balanced Advantage Funds. These funds invest in both equity and debt instruments and shift allocation from one to another based on market movement. So, if markets are going up, the fund will increase exposure to equities, thereby helping you leverage the benefits of equity investing. On the other hand, when markets are going down, the fund will reduce equity exposure and increase exposure to debt investments, thereby safeguarding portfolio downside. This way, you don't need to worry about timing the market and can mitigate the impact of behavioural biases on your investment decision making.

With the right mutual funds, reducing the impact of behavioural biases can be easy. However, before you decide to invest in mutual funds, it might be best for you to consult a financial advisor and then choose to invest in funds that meet your requirements.

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