TJT CAPITAL GROUP

The Psychology of Investing

On October 22, 1999, an initial public offering (IPO) of Sycamore Networks began trading. The new issue was priced at $38 dollars per share, and the first trade was at $270 7/8 giving it a market value of approximately $20 billion. It managed to close the day at $184 ¾ up 146 ¾ points for a market capitalization of roughly $14 billion. That for a company that had lost $20 million on $11 million in revenue.

On March 10, 2000, the NASDAQ recorded its closing high of 5,048.62. On that same day, shares of Berkshire Hathaway class-A, managed by one of the most successful value managers of all time, Warren Buffett, made a multi-year low of $41,300. Over the next seven and one-half years, shares of Berkshire added more than $100,000 per share while the NASDAQ was cut in half.

Many years later these valuations seem insane. Why were the majority of investors clamoring for technology stocks at outrageous valuations while ignoring valuable opportunities? It can be explained through a better understanding of the psychology of investing.

An analysis of market history shows that money tends to flow not to the best investments but to the most popular ones—those that have done well recently. A rising price attracts new investors like a moth to a flame. The increasing returns suck in more and more players, resulting in even higher valuations. An increase in price momentum creates optimism, which further leads to increased confidence, and, at the extreme, outright speculation.

According to Vanguard founder John Bogle, investors poured $18 billion into equity funds in 1990 when stocks were cheap and $420 billion in 1999 and early 2000 when stocks were grossly overvalued—with most of that money going into aggressive growth funds. Not only did they pick the wrong time, they picked the wrong funds.

Although some investors might be hesitant to participate, the lure of easy money and high returns is hard to resist. Investors have a long habit of chasing past performance by allowing their emotions to overcome reason. Many are influenced by what others are doing and saying, and therefore, don't want to be out of step. There is a belief that "they" must know more. If people think they are getting "a free lunch," many will take it.

Moreover, many of the "asset gatherers" in the investment industry play on these emotions by bringing out new funds or products to meet the increasing demand or, in some cases, promote the fads of the day. The promotional tone is often mirrored by those in the media, making it even harder to resist.

However, we know there is no free lunch. Or, as a notable money manager likes to say, "Someone's paying for lunch." Capitalism has a way of making a good idea at a low price a bad idea at a high price. The greatest booms and busts in history have occurred when capital concentrates in one market or sector. Fast money speculators can make a lot of money; they just can't keep it and suffer net losses when the inevitable lunch bill arrives.

It is said that "investors fight the last war." That is, they have a tendency to invest looking through the rear-view mirror instead of looking through the windshield. The windshield involves uncertainty, which tends to be an uncomfortable feeling for many. However, it is the uncertainty, which is likely reflected in the price of an asset, which creates the potential for incremental return.

When markets are under serious selling pressure, you are not human if you are not scared. Prices are subject to irrational and excessive price fluctuations in both directions. Yet the best investments often arise when other investors act unwisely, thereby creating potential rewards for those that act intelligently. The key is to exploit the excessive optimism and excessive apprehension of the speculative public.

Successful investing involves knowing what not to do, knowing what to avoid, and setting out with realistic expectations. It means pursuing a long-term strategy with a track record of success—one that has the general principles and characteristics to provide a satisfactory return—and apply it with discipline even though it may not win the performance derby every year.

No single strategy is going to perform well each and every year. However, that does not mean you should hop from one strategy to another in the hope of guessing correctly. In order to outperform long term you must be willing to go against consensus when your analysis dictates. It means being willing to underperform from time to time and to think independently regardless of what the herd is doing. In the long-term that's how you leave the herd behind.

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