PHILEQUITY CORNER

Fear Factor

By ARSamson

The eponymous reality show features contestants being put in situations which stoke their deepest fears. Surviving their phobias, they allow themselves to be subjected to creepy situations like being lowered into a tank full of small rats or snakes crawling all over their bodies or walking a tightrope to pluck flags against the time of competitors. While the show's producers are aware of lawsuits from things turning nasty by providing safety features for even the most dangerous-looking stunts, the fear factor is definitely there for the audience to see and vicariously experience. Except for one episode involving Caucasians eating a fertilized duck egg (*balut*) viewers in these parts will find most of the stunts too scary to get into, even for the top prize of 50, 000 devalued dollars.

Does our stock investor experience this gut-wrenching experience without benefit of a safety harness or a bucket for throwing up? Business programs attempt to feature a balance of optimists (It's time to buy) and the-sky-is-falling doom merchants. Still, the fear factor dominates. Even the metaphors employed are turning nasty. One TV economist in Bloomberg likens bargain hunting or buying stocks downwards to lower average cost as a case of "catching a falling knife" (ouch).

When things are getting gloomy, it's time to turn to history. One recent Asian Wall Street article describing the sub-prime crisis mentions a book, Charles Kindleberger's "Manias, Panics, and Crashes: A History of Financial Crises" (1978). I remember having picked up a copy of the same book at a university bookstore in one visit to my son when he was taking up his MBA at Wharton about ten years ago. (I also picked up a sweatshirt with the stenciled words "Wharton Dad".)

Kindleberger has written a historical analysis of financial crises, similar to our current sub-prime crash. The good news, in his analysis of these crises as cyclical, is that the market always comes back up with a vengeance. (A previous piece in this corner has tracked more recent "corrections". This exuberance followed by waking up in an alcoholic daze was also encountered in the heady dot-com bubble from 1995-2001 when one company called "Pets.com" that delivered pet accessories and food from orders placed on the Internet went on an PO and promptly liquidated nine months after. But before that, the upstart dot-com companies exceeded market caps of established giants like GM or Disney.

The business model of the dot.com companies involved racking up losses month after month (called a "burn rate") as they gave away their service almost for free to accumulate more and more eyeballs. If this looks silly on hindsight, what about our last incarnation of giving loans to NINJAS (No Income, No Jobs and Assets) and then turning around and selling these high-default instruments to other parties, like (ehem) banks?

Kindleberger who wrote his book thirty years ago with three updates up to the edition I read (1996) cites the famous South Sea Bubble (1711-1720). The South Sea Company was supposed to be doing business in Latin America, and among its lines is the trading of slaves. People bidded up these shares and increased their value ten times within a year.

Isaac Newton, an eminent scientist who discovered the three laws of motion (third law: For every action, there is an equal but opposite reaction) and also the law of gravity was himself a speculator (defined as an investor who lost money) in the South Sea Company. He confessed after his sad financial experience that "I can calculate the motions of heavenly bodies, but not the madness of people."

Newton was not an absent-minded professor who did not understand economics as he was Master of the Mint in his time, a position similar to our modern central bank. He appreciated the folly of the South Sea business model and sold his shares early making 7,000 British Pounds and a hefty 100% profit. But, and here's the foolish part, when the stock kept going up after he sold, he reentered the market and thereby lost 20,000 Pounds. Now, isn't that a familiar story of seller's remorse followed by simple remorse?

A rational investor too can be sucked into irrational attraction, especially if he is wise too early. When all about you are making money as you point out the craziness of the scheme, maybe you should line up too and throw caution to the wind. Kindleberger asks, "Are markets so rational that manias—irrational by definition—cannot occur?

So, what does this history lesson have to do with the volatile stock market?

Kindleberger charts 34 financial crises from 1618 to 1990. Clearly, manic cycles seem to pop up routinely and almost on schedule, much like solar eclipses. Those who do not read history are doomed to repeat it. But do those who read history have to be recluses?

It seems to be the big boys managing large funds that took the biggest hits, because they make the biggest bets. It's true that funds handle Other People's Money (OPM). They may not have the same sense of deprivation when their bets turn bad. True, their bonuses may not be as hefty any more, or they may even lose their jobs, but their clients certainly feel the pain more intensely than their postponed purchase of a Chinese painting. So, those turning over their money based on Other People's Expertise (OPE) must not fully relinquish their own responsibility for the choice of investments.

A private investor must also understand what kind of stocks or investments his fund managers put his money in. A transparent listing of stocks and full explanation of the risks involved in the instruments offered is necessary. And here's another rule to remember—if you don't understand how an investment instrument works after your fund manager has explained it, maybe you should put your money somewhere else. Not understanding the intricacies of an instrument doesn't mean you're stupid. There's a possibility the scheme really doesn't make sense.

The fear factor should be used constructively as a sixth sense of evaluating risk and rewards. Fear shouldn't drive us completely out of the market. It should allow us to be more discerning. If an animal's fear triggers the choice of "flight or fight", an investor's fear should lead to a flight to quality…even if the yields are more modest, and therefore credible.

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