PhilEquity Corner
17 January 2011

Are You a Rational Investor?
By ARSamson

Behavioral economics is not really as new a branch of the dismal science as it appears. Psychology has always determined economic behavior. Adam Smith himself who lived in the eighteenth century though famous for his “Wealth of Nations” (the abbreviated title) and the theory of the “invisible hand” wrote another book “The Theory of Moral Sentiment” that delved into the psychological explanations of man’s actions including his economic ones. That the adopted father of the free market also studied morality only shows that he was ahead of his time.

More contemporary writers like Tim Harford (Undercover Economist) and Steven Levitt and Stephen Dubner (Freakonomics) delve on the psychological drivers of economic decisions—like why parents bequeath more to their grown-up children who visit them regularly. The model of the consumer in classical economics is a construct known as “homo economicus” that is always looking optimizing monetary value and weighing options with only money in mind, looking for complete information on other options and opportunity costs. This type of behavior seems no longer to describe real life and how consumers or investors behave. Emotions like need for status and respect intrude.

The investor relying solely on quantifiable data like price/earnings ratios, times over book value, present value of an acquisition will always be there, usually in the research departments of banks or stock brokerages. Not only are statistics usually late in coming, but they can sometimes unreliable. Meanwhile the gaps are filled with forecasts and corporate plans which also don’t always materialize.

Economics is not an exact science the way physics and metallurgy are. It is more akin to the social sciences like psychology and the behavior of crowds. Every investor has a psychological profile which determines how he makes investment decisions. The investment adviser needs to ask her client whether she is after safety of her investment or growth. This dichotomy is a lot richer in actual practice. The choices have to do with risk appetite balanced with expected returns. With each decision made, the investor can check whether he likes numbers and data or goes with his guts or does a little of both.

Are you a rational investor? Here are three decision points that define your profile.

How do you pick stocks?
Professional analysts offering stock picks look for “themes”. These are usually the flavor of the month or quarter. If gold and oil are moving up, which they seem to usually be doing, commodities become a theme. Are inward remittances still climbing? Then the theme may be property stocks or food and retail because of the higher purchasing power of the recipients. The search proceeds with a hunt for undervalued stocks with a high upside. The undervalued status may be a result of plans not yet publicly disclosed, say an acquisition or the discovery of an oil well (this doesn’t seem to be much in vogue nowadays). Undervaluation is expressed in terms of

times over book or price earnings ratio, often compared to peer companies here or in the region. Even this seemingly rational approach has a bit of an irrational element. But like Facebook friends, many investors use word of mouth recommendations in picking a stock. An acknowledged punter with a good track record is asked for a hot tip. And then it’s off to the races. You manage to ask about holding period is and the target price. True to an irrational bent, you are likely to ignore the numbers anyway. There are just too many charts to look at.

When do you buy?
After picking a stock, it is a matter of buying it. Do you buy at the opening price right after deciding on the stock? Some factors like yesterday's trade whether closing at asked or bid price and what volumes are on either side determine how the opening price will be like, unless some Portuguese story gets in the way. Here the market itself can show irrationality. Do we even trade with Portugal or expect the decline of Portuguese tourists—well the fund managers with a global portfolio do not bother to explain their hasty departure.

But you have to remember that the market is never wrong just as the priest is never late for mass. Impatient investors put their investible funds in one purchase with volume and price in one go. Is averaging up or down really better? Since the market is volatile, going in at one price is akin to betting everything in one draw of the cards. Note the casino reference in this particular subject. The game of chance and risk management provide lessons applicable to both casino and the market. Some say there is really no difference, except that in the market they don't serve drinks.

When do you sell?
It's all paper profits or losses until you sell? This is the most important decision for the investor. Is it rational to sell the rising stocks and hold on to the dogs with the hope of the latter making a comeback? Even selling at a loss for a stock that is barking and barfing like a dog can be a sensible move. Or unloading at a price that seems to be zooming up in defiance of gravity because, you are told, foreign funds want a piece of the action. Even when the left side of your brain is telling you that it can't keep going up and that its PE ratio is already touching the clouds, you hold off and sometimes get rewarded.

The irrational investor keeps checking the price of a stock he has already fully sold yesterday at a hefty profit, maybe 200%. But he still experiences seller's remorse as the helium- filled balloon continues to soar, even after he has deleted the stock from his watch list. Never does he console himself with the thought that a triple digit return not even annualized is a great thing. He's thinking of how much more profit he could have made. Of course, if the stock finally does a splashy dive, he is elated...and then proceeds to get back and buys the stock again. This story seldom has a happy ending.

Stocks are not only about investing. They are topics of conversation among business cognoscenti, interwoven with the tabloid aspect of the protagonists, and filled with bragging rites. It is not possible to take the emotion out of the investment equation. A lot of it has to do with what happens after the market is closed.

Market sentiment is the aggregate sum of individual emotions playing into every decision to buy or sell. The behavior of the investor adds up to an occasionally irrational market. It is then good

to recall that famous quotation from John Maynard Keynes who was both an economist and a market player—the market can stay irrational longer than you can stay solvent. Numbers don't always add up, but feelings about the market always do.

For further stock market research and to view our previous articles, please visit our online trading platform ***www.wealthsec.com*** *or call 634-5038. Our archived articles can also be viewed at* ***www.philequity.ne****t.*