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PHILEQUITY CORNER

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Investing in sentiment

Even actions like raising tariffs on exports by an increasingly isolationist economy can quicken the pulses of the global economy. Is local market sentiment affected? Even if the Philippines may have a comparatively tiny export (USD 16 Billion) to the biggest economy in the world, the aftershocks of this global earthquake can reach its shores. Sentiment can rule market behavior.

Sentiment, deemed as an irrational element in an otherwise exact science, has nonetheless 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. Was Adam Smith the first behavioral economist?


More contemporary behavioral economists, like Richard Thaler, cite irrational behavior in investment decisions. For instance, using a ticket to an event, even if one is feeling sick or inconvenient to go due to bad weather so as not to waste the cost of the ticket, is economically an unsound decision. The theory of "sunk cost" states that money spent and no longer refundable becomes an irrelevant issue in any rational decision.

Economics is not the exact science that 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.

Even professional investment analysts offering stock picks may look for "themes". These are usually the flavors of the month. If gold and oil are moving up, which they seem to usually be doing, commodities become a theme. If inward remittances are dropping from mass deportations of fellow nationals in the States, the theme of property stocks and other consumption goods may likewise be abandoned.

Themes are determined by sentiment combined with analysis of hard data.

It's good to remember that it's paper profits or losses until one actually sells? 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 emotional investor keeps checking the price of a stock he has already fully sold the previous week at a hefty profit. But he still experiences seller's remorse as his helium-filled balloon continues to soar, even after he has deleted the stock from his watch list. If the stock finally does a splashy dive, he is elated...and then proceeds to get back to the stock again. This story seldom has a happy ending.

The market is never wrong, even when it goes against the prevailing sentiment among the investors. Impatient investors put their investible funds in one purchase with volume and price in one go. The timing of the principle of “buy low and sell high” is hardly a rational approach. Can't a low price still go even lower?

Market sentiment is the aggregate sum of individual emotions playing into every decision to buy or sell. Is the rational investor safe in an irrational market? It is good to remember John Maynard Keynes's warning—the market can stay irrational longer than you can stay solvent.