How to Keep the Stock Market's Essential Mystery from Hurting You

By Archie M. Richards, Jr.

We consider the following ideas:

- Stock prices are always perched halfway between the opinions of optimists and pessimists. If you wait until you feel safe about the market, you'll wait forever.

- The stock market has an essential mystery. You can't solve it, but you can say to yourself, "The market mystery is over in that corner. I won't step there. I'll walk around it."

- Keep your investment life to yourself and don't become a groupie.

<u>The Market Never Feels Safe</u>

Imagine how we'd *like* the stock market to act:

-- Good news comes out. Stock prices remain down long enough to allow everyone who wants to get in to buy. Prices then rise.

-- Bad news comes out. Stock prices remain up long enough to allow everyone who wants to get out to sell. We're all in while prices are moving up and out while they're moving down.

If buying and selling stocks were that easy, we'd sell our homes, our jewelry, our spouses, and our children, borrow up to our eyelids, throw everything into the market, and come out zillionaires in no time. This can't be. There isn't enough money to go around. The value of stocks can't get too far ahead of the world's real wealth. Real wealth is produced by people pushing, pulling, thinking, teaching, designing, fabricating, and servicing the things we want. To keep stock prices from getting too far afield, the market has to make investors wrong about the short term most of the time.

The second reason the above nirvana won't work: If good news comes out but prices stay low enough to allow everyone who wants to get in to buy, the buyers would have to be observant while the sellers are obtuse. Later, when bad news comes out but prices stay high enough to allow everyone who wants to get out to get out, the *sellers* have to be observant while the buyers are obtuse. This isn't realistic. All of us are observant and obtuse all the time. (Well, I am anyway.) Besides, good news and bad news come at us constantly. It's a jumble out there. The stock market never feels safe.

Here's another scenario illustrating why you shouldn't wait to feel safe before buying stocks: Imagine that the stock market just closed, with the Dow at 11,000 and Intel at 21. Suddenly, columns of exquisite, radiant light appear overhead and a deep, reassuring voice, like a heavenly Darth Vader, says, "There are no more problems in the stock market." Unmistakably divine, it's heard by everybody in their native tongue. You say to yourself, "Well, I guess it's safe; I might as well buy stocks."

But the problem is, everyone saw the light and heard the voice. No one who owns stocks is willing to sell with the Dow at only 11,000 and Microsoft at 21. The next morning, the market opens with prices ten times higher: the Dow at 110,000 and Microsoft at 210.

You wonder, “Gosh, should I buy at these levels?” But you see the radiant light and hear that wonderful voice. Reassured, you buy.

Soon after, the light goes dark, and the voice goes silent. Stock prices plunge right back to where they were, leaving you holding the bag. The only ones who profited were those who were in the market before the divine interference and who sold at prices ten times higher.

There are always reasons not to buy stocks. Prices are always perched between the bulls and the bears. The short term is always a quandary. The best time to buy stocks is when you get the money. The best time to sell is never.

The Market’s Essential Mystery

You may have heard a television market expert say, “Stock prices can’t move up until earnings improve.”

The statement is wrong. Stock prices do not move up after earnings improve. They move up *before* the earnings improve. In fact, stock prices move in advance of *all* business and economic news - about 4-to-6 months in advance. They move before anyone knows the real story. If a company reports good earnings today, the chances are the price of the stock has been rising for months. If a company’s stock price is trending down, the reason why won’t become known for several months.

Current news does affect current prices, of course. If surprisingly poor employment numbers are announced before the market opens, for example, prices are likely to fall that day. But if the news that won’t become known for several months turns out to be favorable, the market’s reaction to today’s bad news will be just a downward blip in a general uptrend.

In the short term, stock prices go up, down, or sideways. Several months later, news comes out which explains why. Prices move in anticipation of news that no one is yet aware of. This is the stock market’s essential mystery. It explains why short-term results from buying and selling stocks are so confounding. If you engage in stock trading on the basis of current news, you’re too late. If you learn about the news before anyone else, you’re still too late. Short term, you’re always in the dark. You’re driving forward in a car when the windshield is painted black and your only view is from the rearview mirror.

How do the buyers and sellers of stocks know what the news will be? Individually, they don’t know; they just guess. Take Coca Cola stock. Millions of people have opinions about Coke’s future, including employees, vendors, soda drinkers, advertising viewers, investors, traders, and just plain people. Some are already owners of the stock; others aren’t. Some are knowledgeable. Others may know nothing about stocks but contribute money to a 401(k) plan that invests in them. Still others are too scared to buy stocks at all, making the prices lower than if they participated. We can’t *ask* for the opinions of all these people, because too many people are involved. Besides, the opinions may be too subjective to be expressed clearly; they may just be intuitions. The only way we can know what the intuitions are is by the price of the stock. If the preponderance of guesses at a certain time is positive, the price rises. If the preponderance is negative, the price falls. So it goes with every stock – some 65,000 publicly-held stocks all over the world. The collective opinions of millions of people are reflected in just a series of numbers.

It’s not a conspiracy. Most stock market participants don’t even know each other, much less collude. Stock markets are gigantic voting machines. With a stream of numbers, millions of people collectively predict the future with remarkably accuracy.

Collective guesses are more accurate than those of any of the individual participants. Jack Treynor, inventor of the Treynor Method of evaluating risk, placed 850 jelly beans in a glass jar and asked a class of 56 students to estimate of the number of beans. “Write your guess on a slip of paper,” he directed. “Fold and submit the slip without showing it to anyone else.”

The guesses varied widely. Treynor added them up and divided by the number of guesses. The average guess was 871 jelly beans, just 2.5% higher than the 850 correct number. Only one student guessed closer to the correct number than the average. If the number of guesses had been larger than 56, the average would have been closer than 2.5%.

The guesses have to be independent. If the students had been made aware of the estimates of *other* students and skewed their guesses according to what they thought was the trend, a bandwagon effect would have been created, rendering the average guess well off the mark.

A similar experiment took place over a century ago, in 1907, at an agriculture exhibition in England. The experimenter asked people to bet a sixpenny on the weight of an ox. The person with the closest bet would receive the money. 787 people placed bets. The ox’s actual weight was 1,198 pounds. The guesses varied widely, but the average was 1,197 pounds - off by only one pound, an error of only 8/100ths of one percent!

Participants in the world’s stock markets number in the millions. The huge number explains why the prices predict the future so well. Bandwagon effects, of course, do throw off the predictions.

An acquaintance of mine years ago was a corporate bookkeeper. His company was the subsidiary of a larger company whose stock was owned by the public. The affiliate was an important part of the parent. After the end of a quarter, my friend calculated his company’s earnings. He was surprised how favorable they were, and he was the only one in the world who knew the numbers. The earnings, he knew, would have a surprisingly good effect on the earnings of the publicly-held parent. He therefore obtained a mortgage on his house and bought stock in the parent corporation. (This was before insider trading rules became more stringent.) Then he released the good news.

Alas, the stock of the parent company went down, not up. The price had *already* moved up; it had been rising for months. Market participants had *guessed* that the earnings would be good. When they were actually announced, it was already old news. Investors by then were guessing that earnings to be announced 4-to-6 months down the road would be surprisingly poor, which indeed they were.

Keep the stock market’s mystery from hurting your returns: Trade infrequently. Diversify widely, rebalance yearly (see my position paper about investment strategies), and otherwise just hold. Be willing to lose control in the short term. You might as well; you have no control in the short term anyway.

But it’s almost impossible to avoid having *anxiety* about the short term. After all, we live in the now. We may intend to buy stocks for the long term. But we have to do it in the short term, when we’re buffeted by current news.

This helps to reduce the anxiety: Assume that if you buy stocks, they’ll fall in the short term. Assume that if you *don’t* buy, they’ll rise. Take it for granted that no matter what you do, your timing will be off. Whatever happens in the short term, it’s not your fault. Be willing to drive forward while your only view is from the rearview mirror. Don’t tread in the corner where the market’s mystery lies. The less trading you do, the less you need to contend with the 4-to-6-month periods when you have no control.

But the long term? Ah, that's a difference story. All over the world, people are thinking, designing, digging, growing, fabricating, and servicing. This is the true source of wealth. Over a period of years, stock markets rise to reflect the growth, especially if governments keep their interference to a minimum.

Don't Be an Investment Groupie

This is what's likely to happen if you pay close attention to what your peers say about the stock market:

You buy stocks, and they go up. Your friends say, "This can't go on. Better get out."

You sell.

But the stocks continue rising. After a while, your friends say, "Wow! The economy is strong. Earnings are terrific. We're in a bull market, man. Better get in before the prices run away for good."

You buy.

The prices start falling. But you say to yourself, "Rome wasn't built in a day. I was wrong to pull out before. This time I'll stay in for the long pull."

The prices fall in earnest. You say to yourself, "I'm no good at this game." But you hang in there.

The market goes down big. You've lost the profits you made before. Your friends say, "The news is awful. Prices are going down. Get out, get out!"

You stay in.

Your friends were right. The news gets worse, and prices fall further. You should have sold.

One day, the prices plummet on panic selling. You can hardly breathe. You hate the day you were born. In desperation, you sell.

A few minutes later, the prices start rising.

Two months later, prices are significantly higher. But the news continues to be poor. Your friends say, "With earnings this bad, prices can't stay up." You're glad you're out.

The prices rise more, and now the news itself improves. "Never mind," you say to yourself, "I won't have a wealthy retirement, but at least I'll have something. The stock market isn't for me."

The market goes to new highs, and the news becomes just wonderful. Your friends tell you, "Everything looks terrific. Whaddaya say, man, how about buying stocks?"

You buy.

The prices then begin . . .

Meanwhile, one of your acquaintances, who doesn't talk about her investments, put about the same amount of money into stocks at the same time you did originally. But when prices fell, she stayed in.

When the news became unpleasant, she didn't watch TV business shows. Still in the market, her portfolio is now considerably larger than yours.

In the short term, the stock market is as ornery as a female leopard defending its young. But in the long term, the stock market turns into a pussy cat. In the short run, we don't know what prices will do. In the long run, they go up. Therefore, the time to buy stocks is when you get the money. The best time to sell is, well, never.

If you trade every couple of months, you're continually in the dark. But if you buy and hold for years, you'll come out fine. Oh sure, bad markets occur from time to time. But just ride through them. Turn off the TV. Stop checking stock prices. Do whatever you must to avoid selling when the news is bad. My position paper about investment strategy suggests an approach that reduces a portfolio's volatility. This helps you endure bear markets without selling.

Treat the market as you do a saw when you're sawing wood. If you press on the saw, it binds. Instead, keep the teeth in contact with the wood and let the saw do the work.

Let the stock market do the work. Give it time. Don't try to outdo the market. In the long run, people will create wealth for you. You have only to ride on their shoulders.