CARLSON FINANCIAL MANAGEMENT

MARKET MYTHS

Serious investment is a prosaic activity. It involves putting money aside and patiently waiting as it grows over time. The stock market, on the other hand, is the homeland of soaring financial hopes, dreams and delusions. No other investment form is as suited to provide excitement. No other looks so much like gambling. The market floor is noisy, people shout out offers and trades, lights on big boards flash, prices go up and down with every sale. At the end of each day we can add up the score, how much won or lost, and how much we have in the portfolio. Not surprisingly, investors' myths are generally similar to gambling mythology.

Uncle Joe and the Guy Down the Street

Both of these characters got rich in the stock market. We know it because they constantly remind us. Joe bought IBM at $2 and retired twenty-five years later when it hit $100. The other guy always had just the right collection of tech stocks during the dot.com boom. He retired after just five years. If asked, they will reply demurely that they were just lucky, but deep down they and everybody else believes they are smart. With great vision and strength of will they mastered a wild and seemingly unpredictable stock market. Everybody else must be stupid when their investments make a mere 10 or 15%. If there are losses, well it's just bad luck.

Actually very few people, maybe none, get rich in the stock market if "get rich" means investing $10,000 and walking away with $1,000,000. Uncle Joe and the guy down the street fail to mention any of their losing trades. 99 out of 100 people who buy a $2 stock will sell it by the time it hits $4. Ordinarily that would be the smart thing to do. It is exponentially more likely the stock will fall back to $2 than that it will go to $100.

The real reason why these guys could retire turns out to be much more ordinary. The guy down the street is independently wealthy, uncle Joe actually worked for IBM and the stock was locked into a retirement account.

People who get rich in the stock market are generally people who own the company or have employee stock options before it is listed on the stock exchange. They are rich because they built the company, not because it subsequently issued publicly traded stock. Even Warren Buffet, the gold standard of investment managers, did not make his fortune as a stock picker. Actually he located companies that had promise, acquired a large enough position to give him control, rearranged the companies such that they could fulfill their promise, and then moved on with a lot more net worth. In other words he is a business genius, not an investment savant.

The Rich

The Rich are also known as the Smart Guys or the Big Boys. Since they are the ones who make things happen it follows that where they put their money is the place to be. They have the secret knowledge, know the angles, talk to the other people who decide in which direction the world will move. When we hear of exotic investments we can be sure that the rich will have some money there. Hedge funds, “derivatives”, foreign stuff, “private placements”, all are part of a long parade of hot things in investment. Putting money into something not generally available to ordinary folks does have a certain snob appeal, but economic history is littered with the wreckage of the “next hot thing”. It would be nice to think the smart guys are doing us a favor, dumping money into the colossally dumb projects while we enjoy the luxury of waiting to see what happens. Unfortunately there is an intervening stage when sophisticated investment vehicles are packaged and sold to the public, always with the message that this is where the smart money is going. It may be hard to resist impressing friends by talking loudly about a hedge fund investment, but it would be a good idea to resist that temptation.

Market Marxists

Market Marxists are the intellectuals of the investment world. They are the cool operators who look through the froth of daily market movements to find the underlying formula which will allow us to confidently predict the future. In their minds the market is a gamble only because most investors are suckers. Their approach is always the same: select a few financial characteristics and see how stocks which have these characteristics have done in the past. There is just one tiny flaw in this approach. Since we already know how the past turned out it is not real hard to find the peculiar characteristics of the stocks that did well. The obvious question for these analysts is that if their formula is so good why aren’t they rich. Their cynical answer might be: I am rich. I made money selling advice based on my theory.

Professional historians long ago gave up the idea that history is like science. If we see a pattern in the past it does not mean it will repeat itself in the future. History is a guide, not a rule. Market history can teach us that there are important things to look for. But those elements will interact differently at any given time. Every day, each year is a unique event.

Investor Mistakes

Investor mistakes are generally gambling mistakes. The most common is to believe that some special insight, some exceptional intuition will discover just that stock which will rise way above the rest. A portfolio then becomes a collection of hot picks and sure winners. When one of these does especially well it reinforces the investor’s confidence in his capacity for special insight. Portfolios are littered with stocks still waiting to demonstrate what was once their dazzling future.

Another blunder is to chase after the most exotic, the least well known kinds of investments. Of course, the thinking goes, the vast majority of investors are sheep being fleeced by insiders who have a monopoly on the good stuff. The majority don't even know they are in a casino, how could they understand that the sure bets are being made in the manager's office?

Finally, we have the belief that if enough information is collected and it is analyzed with enough critical rigor, then investment is no longer gambling, it is science. Here, "smart" does not mean having special insight or secret knowledge. This kind of smart is the sort tested by the SAT.

The solution is to give up the idea that investment is a branch of gambling and that we are going to "beat the market" by being smarter than the others. Investment involves unpredictability, hence risk, but it is not a zero sum game. Investment means putting resources into productive activities. History does teach us that we are good at coming up with better tools. These make us more productive and consequently richer. Common sense, patience and a willingness to live with the market's meanderings are the best bets.