BELIEVING IS SEEING

How often have we heard the expression “I would not have believed it if I had not seen it”? However, with respect to the stock market, investor sentiment and psychology sometimes bring about a believing is seeing condition that can justify or sustain a market trend. Individual biases and the interplay of fear and greed impulses often cause the market to overreact to what is really happening. Accordingly, the values of shares expressed by short-term prices can become mispriced compared to stock prices based on the future expectations of a company’s earnings and free cash flows. Because investor behavior is subject to emotional vulnerabilities there is a tendency to believe in stories and predictions if they support what we want to believe rather than facts as a basis to buy or sell a stock. Therefore, the market prices we observe daily are not derived with the precision of a chemical formula to reflect true values. This explains part of the reason that a good company is not always a good stock due to price. Stock investors taking this into account will seek exploitable price moves that diverge temporarily from values defined by company financial fundamentals.

Initial public offerings of stock by a company offer frequent examples of investors wanting to believe a story and who have a get rich quick approach. Investors in IPOs are not equally informed. The uninformed investor, driven by excessive optimism or the popularity of a compelling story, may put in to buy shares, but because of the more or less limited number of shares available at the offering is most likely to only have their allocation filled if informed investors have stayed away. So whereas it might occur to a skeptical person that the owners of a private company would wait to sell it at its highest price to the public, the buyer of the new shares is caught up in the emotion of believing what they want to see.

Take, for example the IPO of Twitter (Chart #1). The technology sector has the aura of past riches and the unlimited prospects of fast moving invention and innovation. Social interaction made possible by constant connection and changes in interpersonal communication would surely mean Twitter would be a winning stock. The shares went public in November, 2013 at $26. On January third, 2014 it hit its all-time high of $69. Today the shares are trading at $18. The purpose of this example is not to simply show a stock that has declined dramatically in price, but rather to highlight the way investors can be
defeated by their own psychology, which is a vulnerability of being human. The chart below for Twitter contains, in some part, the peaks and valleys of the emotional content investors brought to the stock price, ending lately in the all too familiar poor long term performance of small company IPOs. Along with the buyer’s optimism one often finds firms taking advantage of opportunities to sell to the public when investors are willing to over-pay because of crowd sentiment. Ultimately, the shares will be priced on sales and profits. Each day the stock’s potential is based on the constantly moving long-term view of these aspects. The long run pricing of the shares will be made up of all the short-term decisions made about the stock, some informed, others emotional.

Chart #1

Investment implications:

Stock investors who observe over optimism or skepticism about an individual stock or in terms of the market itself are in a position to take positions contrary to the crowd. I don’t wish to say the crowd is always wrong, but that popular notions have a way of overshooting turning points, often reacting to a past event.

We can chronical dozens of past panic attacks for the stock market. In Chart #2, just since the 2014 market low, there are many times where an investor could have been a buyer or seller who took a contrary position during one of these panics. To mention a few examples; in 2014 the market sold off in response to the Crimea incursion, then a Yellen rate hike scare, followed by the ISIS invasion of Iraq, Russian sanctions, Ebola scares and finally a big drop in oil prices. Nevertheless, the market was up over 11% from start to finish of 2014. The stock market’s responses to these events were not based on solely rational or predictable decisions from investors yet by the end of the year prices came to better reflect values of underlying factors. Crowd opinion can be a skilled master of enthusiasm or fear. We are emotionally wired to want to go with the herd. Try to avoid the enchanting music of Sirens and loud squawks of the scarecrows.
Chart #2

The swings to date since October 15, 2014, with percentage change for each swing.

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