

## **Stock Market Myths**

The year 2006 was a year in which the local stock market suffered, investor confidence was at an all time low and we even saw one company being de-listed at year end. Indeed, it was a year that many would like to forget and not see repeated. However, although the last six weeks of 2006 showed signs of improvement and positive sentiment many investors continue to remain skeptical about investing in the equity market. I believe that this skepticism comes from what I would like to call “stock market myths”. The stock market is not a place for superstition or myths; it is in fact very level headed in nature and there is always a reason for every outcome. While there are many myths that I can talk about, in this article I would like to shed some light on three classic “untruths” which often distorts reality!

### ***Myth #1***

#### ***The stock market is just another casino!***

This is the most common myth and probably the root of all other myths! Many investors believe that investing in shares is a form of gambling. While this may stem from the fact that returns are less predictable than other forms of investments like bonds and certificates of deposits, it is far from the truth! To identify the difference we will need to first have a proper understanding of each.

Firstly, when you buy a share of common stock in a listed company, you are in fact buying into a fraction of the profits of that company. You become an owner and are entitled to a fraction of whatever is left over after all other stakeholders are paid; this is also known as the shareholder’s equity. The common shareholder stands last in line to be paid and it is because of this risk that they demand a higher expected return on investment than a bondholder, for instance. As such, shareholders are constantly trying to assess what will be left over from profits both now and in the future. This is why share prices fluctuate, because earnings are always changing and as such what is left over is always changing, hence the value of shares will change too. While prices of shares continuously fluctuate, one thing remains constant: shareholders expect their returns to be positive and permanent over the long run and also higher than less risky investments. Interestingly, this expectation has almost always been met for as long as common stocks have existed. The trend has been for aggregate shares to move in an upward trend (with fluctuations) over the long term.

Gambling on the other hand is what is known as a zero-sum game, that is, a situation in which one participant’s gains result only from another participant’s equivalent losses. Thus, the net change in total wealth among participants is zero; no wealth is created, it is just shifted from one to another. This brings me to a major difference between investing in stocks and gambling! Gambling transfers wealth from a winner to a loser because it produces nothing; investing in shares on the other hand increases overall wealth because the capital invested in shares provides the initial funding for firms which exist for the purpose of producing goods and services. Additionally, companies are continuously competing and trying to grow their bottom line for shareholders and in so doing increase productivity which translates into wealth

creation. Thus, aggregate wealth increases for society as a whole. The same cannot be said for gambling!

Another difference between gambling and stock investing is the fact that there is usually a steady upward progression in the value of stocks in the long run. In gambling however, the longer you stay at the gaming tables- the more likely you are going to walk away a loser. Indeed, investors do lose money holding stocks, but once you have a well diversified portfolio chances are that your portfolio will increase in value over the long term.

I hope now that every investor understands that gambling and equity investing is like apples and oranges, you can't compare them! Once you understand that they are not one and the same it should give you the confidence to pursue a long term plan for investing that will make you less prone to the destructive forces of fear and greed.

### ***Myth #2***

#### ***Fallen Angels will go back up***

This myth is also known as “Buy Low and Sell High” and could be your mantra to the poorhouse! An investor cannot make a bigger mistake than buying a share whose price is falling or trading at an all time low based ONLY on the assumption that it once traded at a higher price. While buying at a 52-week low brings some sense of security, it can also bring false hope. There is a very thin line between fallen angels and shares headed straight for the fires of bankruptcy. A classic example of this would be BWIA- we all know where they landed!!!

A share that once traded at a high price may have done so because at that time the company's fundamentals were positive and so were future prospects. However, business conditions do change and that same company could have experienced something that changed optimism surrounding its share and as such its price could be expected to fall tremendously. It is therefore important that you are aware of the fundamentals of the company in which you are investing in addition to the technicalities of its price.

When investing, the idea is to buy those shares which are undervalued based on fundamentals. In other words a share price may be low in comparison to forecasted earnings and this would indicate that the share price is deflated and will eventually be corrected through price appreciation. In this case you would buy at the low or deflated price and sell at a price that you believe is the true value of your share, that is, a higher price.

Typically, investors seeking value will select shares with lower-than-average price-to-book or price-to-earnings ratios and/or high dividend yields.

### ***Myth #3***

#### ***Stocks that go up must come down***

Indeed this would be true if a stock price had some physical weight and then we could apply the law of gravitation- what goes up must come down! However, in reality the movement in a share price is not determined by any gravitational force.

As discussed in Myth 1, shares tend to move in an upward direction in the long run, advancing to new highs. This does not mean that share prices do not undergo corrections or price drops, but once the price is a proper reflection of the value of the company then it is not unusual for a share price to continue rising.

Table 1 shows the percentage gain over five (5) years for companies listed on local stock market. I have chosen one company from each of the main sectors (Banking, Non- Banking and Finance, Conglomerates, Trading and Manufacturing, respectively)

**Table 1**

<b>COMPANY</b>	<b>SHARE PRICE AS AT 4/01/2002</b>	<b>SHARE PRICE AS AT 2/01/2007</b>	<b>% GAIN</b>
<b>Republic Bank Limited</b>	\$35.00	\$84.00	140.00%
<b>Ansa Merchant Bank Limited</b>	\$5.40	\$18.69	246.11%
<b>Neal and Massy Holdings Limited</b>	\$13.80	\$42.66	209.13%
<b>Prestige Holdings Limited</b>	\$3.40	\$5.50	61.76%
<b>West Indian Tobacco Company Limited</b>	\$9.55	\$24.00	151.31%

As can be seen from the table, each of these shares showed a positive return over the long run (5 years). Indeed, there were times when each of these shares had a fall in price but it did not mean that they were on a never-ending decline.

So while some might argue that a share's trend is a series of ups and downs and hence believe in the myth of "what goes up must go down"- they should keep in mind that over the long run the net position is almost always positive!!

So let's leave the myths behind this year and move into the future with a realistic view of the stock market!