

# Greed, *fear*

and the psychology of share  
market investing.



**Tyndall**

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# Market efficiency

What is a truly efficient market? And why does it matter?

Share markets should work efficiently – that is, all known information about each organisation should be built into all share prices on a rational basis.

Efficient market theory assumes two things:

1. that there is rational behaviour from all market participants; and
2. that all known information about a company has already, rationally, been built into the share price.

The logical conclusion of this theory is that stock markets present no opportunities to invest in undervalued securities, and so there is no opportunity for an individual investment portfolio to provide additional returns from market out-performance.

## How the market really works

In reality, the market is inefficient. Let's explore why.

### 1. Fear and greed

An efficient share market is a myth.  
Its existence requires all known information to be automatically built into a share price in a rational manner.

But market participants are human, and share markets are affected by irrational human behaviour. Complex human emotions, such as fear and greed, can result in investors buying into stocks at very high prices and later selling those same stocks at very low prices.

Equally, all the information about a company, although freely available, is not always built into its share price. Irrational human behaviour means company information is often discounted, or over-emphasised.

## 2. Herd mentality

The 'herd mentality' is based on a simple premise: "if others believe, then it is safe also to believe". The temptation is to go with the crowd!

It is always difficult to take a view that is against popular opinion, and have to deal with the criticism for holding stocks that appear to be unworthy or inefficiently priced. These judgments occur in market upside rallies as well as market falls. When they occur during market rallies, they can create a period when the market is over-inflated – often call a 'bubble'.

But remember:

- popular stocks are often over priced; and
- when popular stocks disappoint, the resulting sell-off can be severe.



The hardest decision, whether at the level of over-pricing or under-pricing of a market or security, is to take a view that is contrary to popular opinion.

### 3. Greater fool theory

## There is always a greater fool to buy you out at the peak of the market.

Not all participants suffer during a 'bubble': For every buyer there must be a seller. Some share-holders are astute enough to move out of the over-priced market before its collapse. There is even a certain logic to investing in stocks, and backing the momentum of rising markets, based on this 'greater fool' theory.

The problems are:

- market peaks are hard to pick or 'time'; and
- knowing when to make the 'sell' decision is not easy.

### 4. Advice and accountability

## Good advice is hard to find. The loudest and most public information isn't always the most accurate.

The herd mentality is often fuelled by market commentators. Because of their own business objectives, they may be required to 'talk up' the market or stocks.

The fact is, the short-term focus of much market commentary is at odds with the longer-term investment horizon of most investors.

Accountability becomes a problem when investors do not fully assess their performance and detail actual results against market benchmarks. Like gamblers, they tend to bias their success on the number of wins, overlooking their losses or opportunities not taken.

Investors with successive wins can assume a certain arrogance of invincibility that encourages larger 'bets'. Such a belief in their own infallibility can lead to large losses.

## 5. Information overload

“The volume of information cannot be absorbed or logically analysed...”

From 'Fear, greed and panic; the psychology of the stock market' David Cohen 2001.

For the markets to be totally efficient, everyone should know the same as everyone else and be able to act on that knowledge. But with the internet and the sheer volume of data available, it cannot be absorbed by everyone and sometimes illogical conclusions come out of correct information. This can start a stampede.

As David Cohen said, this information overload leads to “magical thinking, authority influence, reality blindness, inability to rationalise or undertake modest mathematical calculations and dependence on hindsight.”



With the sheer volume of information available, no one can absorb all the relevant parts, and sometimes illogical conclusions can come from correct information.

## 6. Theory of cognitive illusion

“The market is overvalued but this time is different and the market norms do not apply.”

The theory of cognitive illusion is simply that, when faced with conflicting information, investors will favour the information that leads to the outcome they would prefer, and will downplay information that leads away from that preference.

It's a gambler's mentality. The thinking is that if I don't invest in the market, even though all the signs indicate that it is overvalued, I may miss out on excess returns. Investors can convince themselves that this time it is different. But what if this time is not any different?



The skill is to see the traps and avoid the common pitfalls.

# What can you do?

Becoming a disciplined investor and being able to recognise the investment traps is not enough. Unfortunately, being disciplined is easier said than done. It is human nature to fall into these investment traps.

What to watch out for:

1. Don't chase yesterday's returns in the hope that this time, it's different. It is important to invest consistently through up markets and down markets in a disciplined way over the long term. The best way to do this is to **dollar-cost-average**. Instead of investing a large amount of money at the one time (and risk investing at the top of a market cycle), invest a smaller amount on a regular basis.
2. Another option is to invest in **managed funds**. They are pooled investments that are managed by professional analysts and portfolio managers who are well trained to objectively analyse stocks and follow tight investment strategies and have rigorous controls. This ensures that the portfolio of stocks in the fund is of good quality and value.



Fund managers use team interaction and follow disciplined processes in order to overcome many of the common traps of investing.

3. There are different types of fund managers, with **different investment styles**. It is important that you seek advice to find one that best meets your investment and financial needs. Team interaction and disciplined processes become a very important factor when you are considering fund managers.

## Doing it yourself is not for the faint hearted

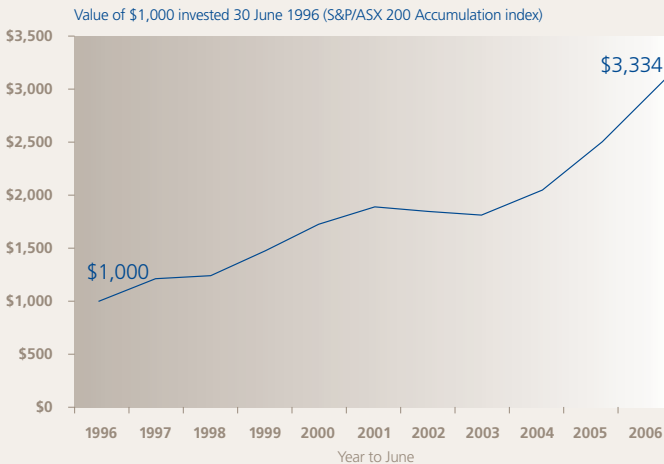
### 1. Stock picking is difficult and time consuming

If share markets rise over the long term, does it matter what stock you pick to invest in anyway? The short answer is 'yes'. Stock selection is vital.

Sure, long term history shows that the performance of the share market, when graphed, is a sloping line that rises inexorably upwards to the right. On the whole, it would appear that the past decade has been a bumper time for shares. But the S&P/ASX 200<sup>1</sup> returns don't tell the whole story.

Looking at the S&P/ASX 200, it would seem that long term investors have done well. As the graph shows, an investment of \$1,000 made in 1996 would have turned into \$3,334 over 10 years.

But to know the true story, a closer analysis of the performance of the individual stocks that make up the share market index is needed.



Benchmark share market indices alone tell only part of the story!

<sup>1</sup> The S&P/ASX 200 Accumulation Index comprises the top 200 stocks listed on the Australian Stock Exchange, as defined by Standard & Poor's, and assumes re-investment of all company dividends

## 2. A closer analysis

### The risk of picking stocks that return less than the index, even in a rising market, is real.

For example, take the year to June 30, 2006. The straight-out-performance figures for the year show that the S&P/ASX 200 (the Index) had a bumper year; it put in an annual return of 24 per cent. But it is only by taking a look at the individual stocks that make up that Index that the real story emerges. As the table shows, only 40 per cent of individual stocks actually out-performed the index. That means 60 per cent of them under-performed the index – in other words, more than half returned less than 24 per cent.

More sobering, is that 21 per cent of them actually put in a negative return – and this in a bumper share market year.

It's worth noting that 2006 is a rather favourable example. Analysing the results of the year to June 30 1998 shows the true danger. The 1998 year was by no means one of the stock markets finest. The total return for the year was only 2 per cent – a sobering result. More surprising, however, is the fact that a whopping 57 per cent of stocks put in a negative return that year.

Year to June	% of stocks with a positive total return	% of stocks with a negative total return	% of stocks that out-performed the index	% of stocks that underperformed the index	Total return for the index
1997	82%	18%	43%	57%	28%
1998	43%	57%	39%	61%	2%
1999	72%	28%	46%	54%	15%
2000	56%	44%	22%	78%	18%
2001	67%	33%	56%	44%	9%
2002	59%	41%	64%	36%	-5%
2003	61%	39%	66%	34%	-2%
2004	85%	15%	50%	50%	22%
2005	88%	12%	41%	59%	26%
2006	79%	21%	40%	65%	35%

Source: Tyndall

Picking stocks that turn out to be poor performers can drag your investment portfolio down – even if the broader share market has had a bumper year.

### 3. Avoiding problem stocks

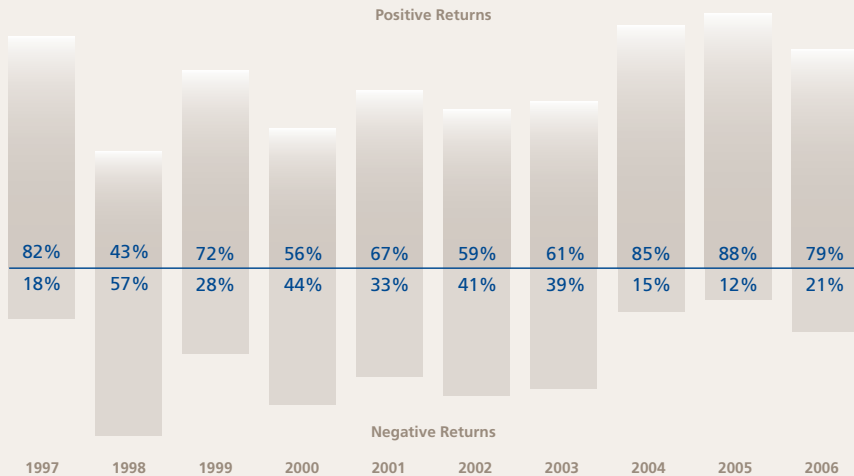
## Even when the market has a good year, there will always be stocks that under-perform.

The trick is knowing how to pick the stocks that will out-perform the market. Even more importantly for most investors, the priority is to avoid stocks that actually lose money.

For Value fund managers – those that have set and disciplined processes in place that allow them to spot the diamonds in the rough – it can be a straightforward task. For individual self directed investors, this is no easy task. As the bar graph below shows, there have been problem stocks in the share market in every year over the past decade.

The extreme example of the year to June 1998 was not an isolated event. In total there were five years in the past decade – 1998, 2000, 2001, 2002 and 2003 – where more than 30 per cent of the stocks put in negative returns.

Percentage of stocks in the S&P/ASX 200 with positive and negative annual returns



Source: Tyndall

Picking stocks is not easy. Even in the so called 'good years' picking the wrong stocks can result in negative returns.

#### 4. Picking market ups and downs

## The temptation is to try and time the market – but it is not as easy as many investors think.

All markets are cyclical, and we know that different asset classes perform differently each year. The temptation is to try and time the market – but it is a strategy that can have dire consequences.

Successful share market investing requires more than a knowledge of the past year's best performing asset class. And sometimes asset classes that are not typically known to be out-performing asset classes can actually do better than the rest of the market.

Looking back over the past 20 years Australian equities have been the top performing asset class six times, while international equities have been the top performing sector four times. Seeing equities out-perform for 10 years out of 20 probably doesn't surprise. It is what many investors would expect. But what of the results from the other years?

#### Surprise performers over the years

If you think you know the way market and asset classes intermix, the following information may come as a surprise. For instance, did you know that fixed interest has been the top performing asset class six times in the past 20 years – as many times as Australian equities!

LPTs have generated a lot of talk in recent years. And it is no wonder – because it is only recently that listed property started to out-perform other asset classes. Looking back 20 years, it was only in 1997, 2001 and 2002 that property was the top performer.

And what of cash? It's an asset class that doesn't get much attention, but it has also had its 'day in the sun' when it out-performed all other asset classes (that was in 1990 when it returned a whopping 18.3 per cent). Recent returns for cash, however, have been more predictably modest.

Who would have guessed?

Year	Aust Equities	International Equities	Cash	Australian Fixed Interest	International Fixed Interest	Listed Property Trusts
1987	54.0%	33.2%	17.0%	13.9%	16.1%	41.3%
1988	-8.6%	-53.0%	12.3%	15.0%	13.8%	-2.8%
1989	3.5%	15.3%	16.0%	7.2%	16.7%	-0.1%
1990	4.1%	5.3%	18.3%	17.2%	13.5%	15.2%
1991	5.9%	-5.8%	13.2%	22.3%	15.3%	7.7%
1992	13.3%	-3.0%	8.7%	22.1%	15.0%	14.7%
1993	9.9%	17.3%	5.7%	13.9%	13.7%	17.1%
1994	18.5%	6.7%	4.9%	-1.1%	1.5%	9.8%
1995	5.7%	3.7%	7.0%	11.9%	12.5%	7.9%
1996	15.8%	27.7%	7.8%	9.4%	11.3%	3.6%
1997	26.6%	26.0%	6.5%	16.8%	12.1%	28.5%
1998	1.6%	22.1%	5.1%	10.9%	11.2%	10.0%
1999	15.3%	15.9%	5.0%	3.3%	5.5%	4.3%
2000	15.5%	12.6%	5.4%	6.2%	4.9%	11.9%
2001	9.1%	-16.0%	6.0%	7.4%	9.0%	13.9%
2002	-4.7%	-19.3%	4.6%	6.2%	7.7%	14.9%
2003	-1.7%	-6.2%	4.9%	9.8%	12.2%	12.1%
2004	21.6%	20.2%	5.2%	2.3%	3.1%	17.2%
2005	26.4%	9.8%	5.5%	7.8%	12.3%	18.1%
2006	23.9%	15.0%	5.7%	3.4%	0.1%	18.0%

Data to June each year.

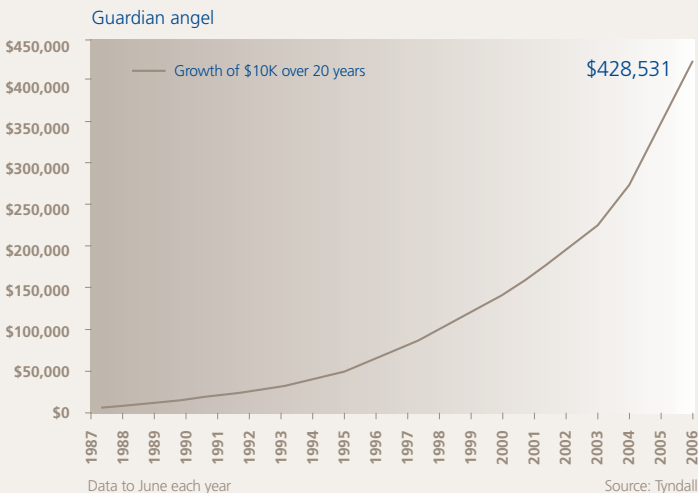
Source: Tyndall

Trying to guess which asset class will out-perform next is problematic at best.  
Markets will often surprise you.

## 5. The guardian angel versus the greater fool

But just say you did know what asset class was to be the next year's best performer. The rewards you would reap would be great.

As the following graph shows, if you did find a guardian angel who 'rang the bell' to advise you which asset class was going to be next year's best performer, and then you invested in that asset class, \$10,000 invested 20 years ago, would be worth close to \$430,000 today.

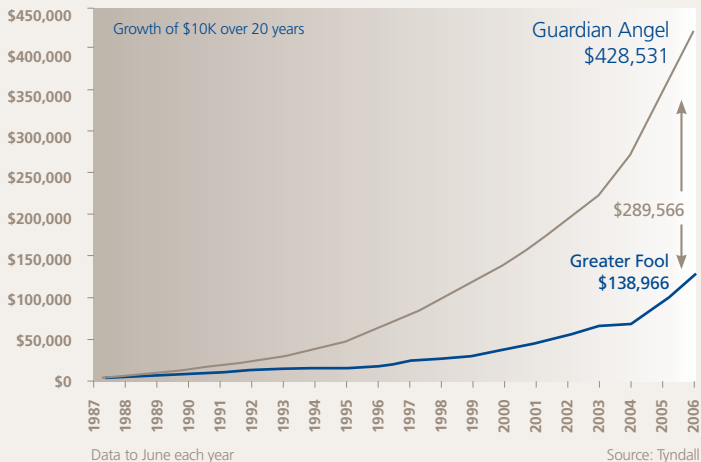


But most of the time we see variations of the behaviour of 'the greater fool'.

The greater fool is the one who invests in the best performing asset class of the previous year – which in most cases does not live up to expectations.

As the second graph shows, this behaviour makes a difference of close to \$290,000 (or over 200 per cent) in the final amount shown. Yes, this example is simplistic and is the extreme case. But it does illustrate the point: there is nothing to be gained in investing in the previous year's best performing asset class.

## Guardian angel vs greater fool



## Where the fool went wrong

Investing in the past year's top performer will almost always be the wrong decision. For example, an investment into Australian equities in 1988 – off the back of the previous year's return of 54 per cent – would have seen an investment return for the year of -8.6 per cent. A fixed interest investment, by way of comparison, would have returned 15 per cent.

Even in good years, for example 1998, when the chase would appear to have paid off with a return of 10.0 per cent from LPTs, the greater fool still would have missed out on returns over 10 per cent higher if the investment had been in international equities (which put in 22.1 per cent).

Of course there are times when the chase really does pay off – for example in 1999 the previous year's top performer was also the next year's top. But how rare is that? Almost as rare as cash being top of the pops!

Picking markets isn't easy – you can't rely on the past year's best performing sector. You need a disciplined process to determine when to buy and when to sell.

# How a Value manager invests

## Let's take a brief look at how Value fund managers invest money into the share market.

When a good stock is neglected and seen as a problem stock (for reasons that may be attributed to fear and greed) – or widely viewed as a 'poor' stock, a Value manager, upon diligent assessment, would objectively determine whether it is indeed a 'poor' stock as the mainstream media and investor behaviour claim OR whether it remains a 'good' stock that has been priced at substantially lower price than it is worth for reasons that they identify.

If it's the latter, the Value manager will go against the selling trend and pick up a good stock at bargain prices, and reap the rewards once the market picks up and when investors revert to their normal behaviour.

The discipline of the Value manager is what we should all preach and practise. But it is often easier said than done, so if you don't think you are up for it, invest with a reputable Value fund manager.

The most famous advocate of Value investing is Warren Buffett – one of the richest men in the world. If you had invested US\$10,000 in Berkshire Hathaway in 1965, when Warren Buffett took control of it, you would have been a millionaire 50 times over by 2003!

Comparatively, the same amount in the S&P 500 Index would have only yielded US\$500,000. A living example of Value investing at work!

## Conclusion

A few key points can be made from this booklet. And it pays to bear them in mind when looking at ways to make money from share market investing.

- An efficient share market is a myth.
- There is no such thing as reward without risk.
- Don't follow the herd.
- Don't be the greater fool.
- Practice dollar cost averaging and diversify!
- Don't try to time the market.
- Don't chase yesterday's returns.
- Leave investing up to the experts, that's what they are paid to do.
- Get financial advice – investing should be viewed as part of your whole financial situation.



Leave investing up to the experts, that's what they are paid to do.







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