Shopping in the Stockmarket

Everybody loves a bargain when they go shopping in the supermarket. This is why retailers advertise "50% off" or "Buy two get one free!" When goods are on special we are more likely to buy them, or we buy more of them than we usually do. This makes sense because we feel that we know their value and if their price has fallen, we are getting more value for each dollar spent on them.

Of course, the reverse applies. Some goods we shop for in the supermarket are offered at prices that change with seasonal supply or other factors. Sometimes they are abundant and cheap, but at other times supply may be scarce and their prices rise. Then these goods are selling at prices that do not represent such great value. We then tend to defer our purchases, or if they are semi-essentials, we cut back how much we buy of them. Value just isn't there at the higher prices.

This is normal rational behaviour when buying goods. It is what most of us do every day. Except that is, when we are shopping in the stockmarket. There we tend to behave quite differently and irrationally. This is because we are being driven by our emotions rather than by our reason. Let me explain…

While looking through the lists of shares we see a retail stock whose shares are selling for $3.20 and that are paying a dividend yield of 5.8%. This looks very attractive against bank fixed interest of 3% and the market's average dividend yield of 4.1%. We decide to look a bit further. We go into our broker's website and pull up a chart of its share price over the last five years and find that it has fallen steadily from $9.70 four years ago. It has not fallen much in the last year, but is still down at $3.20. We feel that there must be something wrong with it and move on to other stocks. Notice the word "feel" here. This is an emotional term. We felt there was something wrong. We did not analyse the situation to see if our feeling was justified. We just acted on our feeling.

What is important here is to see that the way we behaved in the stockmarket is the exact opposite to how we behaved in the supermarket. In the supermarket when the price had fallen, we bought readily or bought more than usual. In the stockmarket we rejected the opportunity to buy at lower prices because an emotion called fear had taken over our reasoning ability.

So, we look a bit further through the lists of shares and find another retail stock whose shares are selling at $4.60, with a dividend yield of only 2.1%. Again, we look at a five year price chart and see that this stock has risen strongly from only $1.30 three years ago. We immediately feel that this must be a great stock. Notice the emotional term "feel" here again. We read some reports about this stock that confirm our feeling and decide to buy it. We did not analyse the situation to see if our feeling was justified. We did not compare it to other similar stocks we could buy. Also, we did not weigh up its value compared to the stock we rejected a short while ago. We just acted on our feeling.

Again, we have behaved in the stockmarket in the exact opposite way to how we acted when we were in the supermarket. In the supermarket, when something was expensive we declined to buy it or if we needed some of it, we bought less than usual. In the stockmarket we jumped at buying when the price was high because an emotion called greed had taken over our reasoning ability.

Good investors do not behave like this. They behave the same way in the stockmarket as they do in the supermarket. They buy stocks that have fallen in price so that their price is low relative to their assessed value. If they own stocks that have risen in price significantly so that their price is now very high relative to their assessed value, they will be selling them to our emotional buyers who are driven by greed rather than reason.

This is sad really. It happens all the time in the stockmarket. The savvy investors buy when stocks are undervalued by the market and sell them to the punters when they become overvalued. However, it does not have to be like this. It is possible to transform yourself from an emotional investor into a disciplined investor who is driven by reason and analysis.

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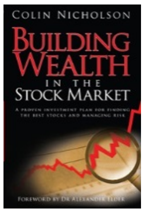

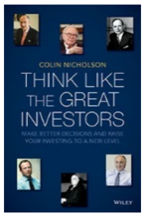

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