Emotions Rule Stock Markets

Human beings are considered to be rational, but are we taking rational decisions in our life always? There may be some yes, but it goes unheard in a loud no. If we had taken rational decisions all the time, today's world (including stock markets) would have been much different. If all the stock market participants are rational, both the risk and reward will be significantly lower than today and scientific/rational theories like Capital Asset Pricing Model (CAPM), Efficient Market Hypothesis, etc., would not have been invalidated in practice. So, it clearly shows that most of the times, not all market participants are rational and they are ruled by their emotions, in particular, the evil emotional twins "Greed" and "Fear". Read on to know more how emotions rule stock markets…

Greed's Rule :

The primary inducement for a new person to enter into the stock market is the stories they see and hear about minting money by their friends or relatives in the bull market. The optimistic amateur newbie will be tempted by the marketing specialists of broking companies (who are looking for potential targets of both men (client) and money (incentives)) to open a trading account and start their journey in hitherto uncharted waters. If we are lucky to make profits in first few trades, then, it will lead to excitement and force us to allocate more money to stock markets without assessing our risk taking ability. On the other side, if we are unlucky, our ego will not let us go out of markets and we will allocate more money to recoup the losses. The relatively much smoother sailing in bull markets compared to bear markets, easy money (profits/gains without much effort) and targets like Sensex @ 100000 by 2022 hyped by media houses will increase the greedy quotient of investor and pushes us to venture into thrills of Day-Trading/Derivatives, without knowing that the world's all time great investor

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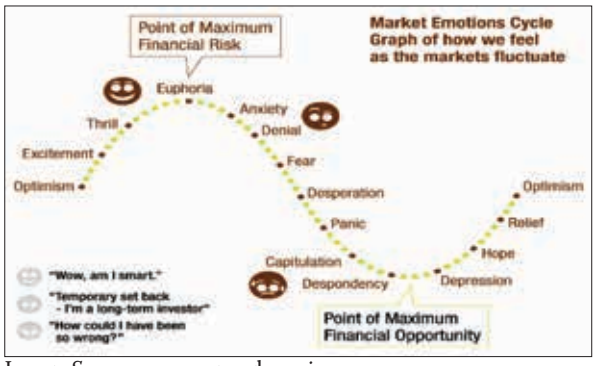
Mr. Warren Buffet termed them as "weapons of mass destruction". Finally, the greedy phase will end with being into euphoric state of trumpeting ourselves as the smartest investor in the world and legendary investors like Buffett, Lynch and others are nothing in front of us.

Fear's Rule :

All is well until the bubble bursts. When it bursts, the money just burns like what happened in January 2008 when the trading was suspended amid benchmark indices (NIFTY & SENSEX) breached the lower limits of circuit filter. The noise of the bubble burst will always be in dangerous decibels, even to make the amateur a deaf when the word "stock market" is uttered. For the participants experiencing such a massive fall for the first time, our greed will be replaced by fear and anxiety, which causes adrenaline rushes and the first thing we know is "I don't know what to do?" After some sell-off, we believe stocks are trading cheaper compared to the peak earlier and deny "it is not a sell-off, it is just a temporary setback". Since we believe that we are long-term investors (without knowing the difference between investor, trader & speculator), we buy more stocks by anticipating that the price of the stocks will soon cross their earlier peaks, but markets does not work that way. To our shock, the indices will continue their downward journey. Now, we could witness two types of participants based on our personality traits. If we are not over optimists, we may sell-off all our holdings (or) we just forgot about stock markets and will never login to our trading account. If we (a newbie witnessing bear markets for the first time) are over-optimists, we will try to average our holdings by buying more, only to pay the price later. Our sailing will not be smooth in bear markets. It will be a very rapid fall with extreme volatility, prolonged periods of low tides and forces panic selling even by the over-optimists. The fear will rule everywhere and we could find some great brands, high quality franchises and companies run by top-class managements at dirt-cheap valuations.

Compared to greed's rule, fear's rule is more powerful and ruthless because even in euphoric times, market may move up in comparatively slow manner than how they fall in bear markets. Generally, bull market takes years to build, but bears don't require that much time. They ruthlessly crash the markets, sets the street in panic mode and paint red everywhere with bloodbath.



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How to Rule Greed & Fear :

To rule (to have a career in) anything, we must know how it works. Stock market is a place where theories were never put into practice because members (emotions) play a major role than numbers (fundamentals). Humans are social animals often driven by emotions rather than rationality and we ourselves don't know how we react in certain circumstances. Stock market is a place, where emotion is the main driver; no one can predict the direction of market with perfection. In case of bank deposits, there is an assured rate of return and return of capital (subject to Deposit Insurance & Credit Guarantee Corporation Cover and so far, none of the banks were allowed to fail in India). In case of land or gold, physical possession of the asset along with multiple utilities of the asset and the status attached with it is a soothing factor when the price/perceived value decreases. However, in case of Stock Markets, we must realise that both Return on Capital & Return of Capital are uncertain and shares held in demat account don't have multiple utilities like that of other assets. This is the primary reason, why emotions (in particular, greed and fear) play a primary role in stock markets. But, investing in shares is like owning a company, the profit or loss, the company is making have to be shared by all these shareholders (owners).

In the initial days, adrenaline rushes will take decisions rather than rational analysis. So, there will be a lot of mistakes and significant amount of capital will be lost in the process. The best attitude is to consider whatever money lost as "tuition fees paid to Mr. Market". So, to have emotional control amid volatility, we must know how much of capital we are ready to sacrifice as tuition fees and for how much rate of return? Knowing answers to these questions will help us taking informed decisions, having a smooth ride in volatility and a peaceful midnight sleep.

If we look back at our mistakes, the most common mistakes will be:

1. **So called Expert Advice & SMS Tips** – We bought/sold stocks based on the calls made by these so called experts in media. Most of these experts' recommendations and tips are made with vested interests and it is a recipe to fall in the trap. If we look at these experts advice, we could see their colour changing skills and speed will put even chameleon to feel ashamed.

It needs consistent practice to put emotions in the backburner when taking decisions in stock market. For doing that, we must be self aware, must spot our weak points in emotional control and take steps to overcome it.

Blinding not following anyone and there is no free lunch in stock market is the first lesson we must learn in stock market.

2. **Gambling** – Almost all the new investors entered Stock markets would have thought it as a place, where money can be minted easily by gambling, but stocks must be considered as a wealth creation and financial planning tool. Our return expectation from Stock Market must be reasonable and we must have patience for the stocks to compound over long-term.

3. **Herd Mentality** – We just followed the masses instead of taking our own decisions. In all the financial markets, the general public (masses) will be the last one to participate because of their inability to control their greed and they buy investments at top of the cycle. We must realise all financial markets will be overcrowded only when the sale is on premium and it rarely finds any buyers when the sale is on discount. Recent Bitcoin episode is a good example to understand this. Everyone talked about bitcoin when it was making new highs every passing hour and most of the people (including people from non-finance background) seemed bullish when the price was at $ 20,000. No one or no media cares about it when it is at $ 8,000. So, we must avoid herd mentality and chasing anything only for returns without knowing the risk attached with it.

If we realise these mistakes after burning our fingers, we could know the only reason we burnt our fingers was "Emotions took centre stage in our decision making rather than rationality and our analytical ability".

Regarding mistakes, even the experienced legendary investors are bound to make mistakes and no one can be right all the times, but most of them rarely get carried away by their emotions. At times, some of the experienced ones in stock market will also get carried away by their emotions mostly during euphoria (out of greed & envy over others success) and panic (out of fear). It needs consistent practice to put emotions in the backburner when taking decisions in stock market. For doing that, we must be self aware, must spot our weak points in emotional control and take steps to overcome it.

The reason why we need a different kind of temperament to be successful in Stock market is everywhere else, we need belly fire to overcome the failures, criticisms, etc., but in stock market having belly fire is a sure shot recipe for disaster. In US and even in most of game related Warren Buffet quotes, most of the analogies are related to baseball. Similarly, in a cricket obsessed nation like India, we could learn our investing by watching cricket. We could always find one thing common between the "best finishers" of the game. They keep their emotions under control, remain cool despite wickets falling at the other end and have enormous patience to wait for the right moment.

There is no other expert better than the individual himself/herself in stock market because the only person who knows much about his personality is individual himself/herself. There is no fixed strategy to make money in stock market. Once we became aware of our personality, we can easily figure out which strategy could work well for us and after a reasonable period of adopting this strategy, we can find the strategy is generating fruitful returns. Once we find our strategy to make money in stock market, there is one virtue that at any cost must be acquired to become successful in stock market is "Patience". Having patience, in a sense, it means "Doing Nothing" and waiting until we get a better deal.

"Stock Market is a device for transferring money from the impatient to the patient".

- Warren Buffett, the inspiration for most people in stock market, once said "I am 85% Benjamin Graham and 15% Philip Fisher". Let us see what Graham and Fisher said about role of emotions in stock market.

"In the short run, the market is a voting machine but in the long run, it is a weighing machine".

– Benjamin Graham

In the short run, just like the eleventh hour election gimmicks, popularity decides voting ; recent news and other happenings, emotions will drive stock prices, but in the long run, the stock price of a company will weigh only the earnings of the company, quality and its prospects.

"One of the ablest investment men I have ever known told me many years ago that in the stock market a good nervous system is even more important than a good head".
- Philip Fisher

Finally,

"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework".

-Warren Buffett ■

We are made wise not by the recollection of our past, but by the responsibility for our future. - George Bernard Shaw