Fear, greed & panic

Eoin McGee explains why longer term investing is much more reasonable and less cruel than its short-term counterpart.

There is a difference between investing in the stock market for the long-term and investing in the stock market short-term. The short-term is getting in and out daily, or at most over a few weeks. This is often referred to as 'day trading'. Longer term investors may be invested for three to five years or more.

The main difference is that a shift in attitude is required. Although both investments are often in shares, the perspective from which you view the investment should be worlds apart.

We can explore this difference by looking at shares in a little more detail. Let's take a start-up business. There are many people in Ireland at the moment setting up their own business and when you do this, it requires an injection of cash at the start to get the show on the road. You'll need money for stock, deposit on the rent, stationery, sales brochures and so on.

The only reason you would put this money in now is because you believe that the business will be successful and you will get your money back plus profits. Now imagine you trade successfully for a few years – you might want to expand or replicate your success in a neighbouring town so you decide to take on an investor. Usually the source of this investor is one of the 'three Fs': friends, family or a fool.

A FLOATING IDEA

Whomever it turns out to be, they put the money into the business for the same reason you did: because they believe they will get their money back plus a percentage of the profits you generate.

10 years down the road, having brought your brother on board five years ago, the product is a roaring success. You are successfully selling into the UK and Europe and all looks good, but you know the product would sell really well in the States.

However, selling into the States means going big-time, you'll need serious capital and unfortunately the family well isn't that deep and certainly, there is no fool big enough around. That is when you consider an Initial Public Offering (IPO). You are going to float the business on the stock exchange.

You'll need to decide where you want the company to be listed – in other words, on what stock exchange will people go to buy your shares.

So you float the company on the Irish Stock Exchange. The big question is: why should people buy your shares? This is where the psychology of investing splits. Admittedly everyone will invest for the same reason you and your brother did – because they believe that they will get at least their money back plus some share in the profits the business generates.

A SHORT SIGHTED VIEW

The shorter term investor has a slightly different agenda. Each day the share price of a company reflects exactly (not roughly or approximately, but exactly) what the market believes that share is worth. Lots of things come into play when deciding the share price but ultimately, it is down to demand.

If the share is in demand, the share price goes up as more and more people buy it. If there are more sellers than buyers, then the share price will go down as the sellers have to lower their price to meet the purchase price being offered by others.

But what drives the demand, or lack of it? For the short-term investor, lots of things. But I think it can be captured in three words: fear, greed and panic. Firstly, the shorter term investor will invest for fear of missing out on something big, the next big win. Once they are in, they can often hang on too long as the greed kicks in and then it goes too far. The share price begins to falter and all three emotions kick in at the same time and they panic and sell off, pushing markets down even further.

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I appreciate that this is an absolute dramatisation, but it is a little insight into how markets can move. You need to consider day trading and the markets' reaction to news in the same way a young child reacts. When they get good news they are running around the garden, hands flapping above their head. When they get bad news, or even better, some gory news, it is tremendously terrible.

THE PROOF OF THE PUDDING...

The markets provided us with proof of this in the last year. We have just witnessed one of the best stock market rallies in history, US markets rose by about 50-60 per cent with Asian markets rising over 100 per cent. This is great when you ride the wave, but it is probably fair to say they went too far too fast. We then witnessed a correction in the last few months with some dropping by 15 per cent in eight weeks. Again, this is too far too fast.

If you have the bottle to ride the markets up and down in their erratic fashion, by all means go for it. But remember, if you can double your money in a day, you can also halve it the next day.

Longer term investors are much more sedentary. They invest in the market today with the bigger picture in mind. The question you need to ask is: do you believe that the company you are investing in will be producing more or less profit in five years time than it is today, and will the share price therefore be higher or lower?

You can afford to strip out the day-to-day news flow that pushes share prices up and down erratically. For the long-term investor, the only real news that matters is the news that will be remembered in five years time.

Longer term investing is much more reasonable and less cruel. You can take a view on the world and where it is going to be in five years time. Never before has that decision been easier than right now. The world is certainly not broken. It's not fixed yet either, hence the turbulent few months ahead, but it is fair to say that in five years time the world will be in a better place than we are right now. So when you see a dramatic headline that has had a huge impact on the day traders, that's your signal as a longer term investor to get in and avail of the discount.

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Eoin McGee is founder of Prosperous Financial Services. Eoin can be contacted at eoin@prosperous.ie, on (045) 841738 or 087 6445533.