Stock Market Price Action and Your Behaviour

Benjamin Graham said:

“The investor's chief problem—and even his worst enemy—is likely to be himself."

99% of investment related content is focused on short term price action. As I write this, we are in December and there will be so much content about yearly performance and what market will do best next.

Stock price action and your reaction

Given Graham’s quote, before looking at an investment, before even putting your money into a brokerage account, you have to first learn about yourself and how will you react if the unpredictable happens on the stock market.

I’ve been investing for close to 20 years now, and trust me, I’ve seen a big deal of unpredictable happen. I am also 100% sure many unpredictable things will happen over and over again. Unpredictability is one of the few things you can be sure of when it comes to the stock market.

In this article I wish to focus on something very unpredictable, which is stock price action, and compare it to business action. Business action is a bit more predictable, much more important, but few focus on it because it is so tempting to look at the stock price, the performance over the year, quarter, month, week or even day.

I am going to give you a few examples of how focusing on stock price action behaviour might cost you dearly in life. I’ll explain what should you focus on, why you should focus on it and how it could benefit you. I am also going to touch on the reason why we as humans like to focus so much on stock prices instead of on business fundamentals over the long-term, the thing that really matters when it comes to investing.

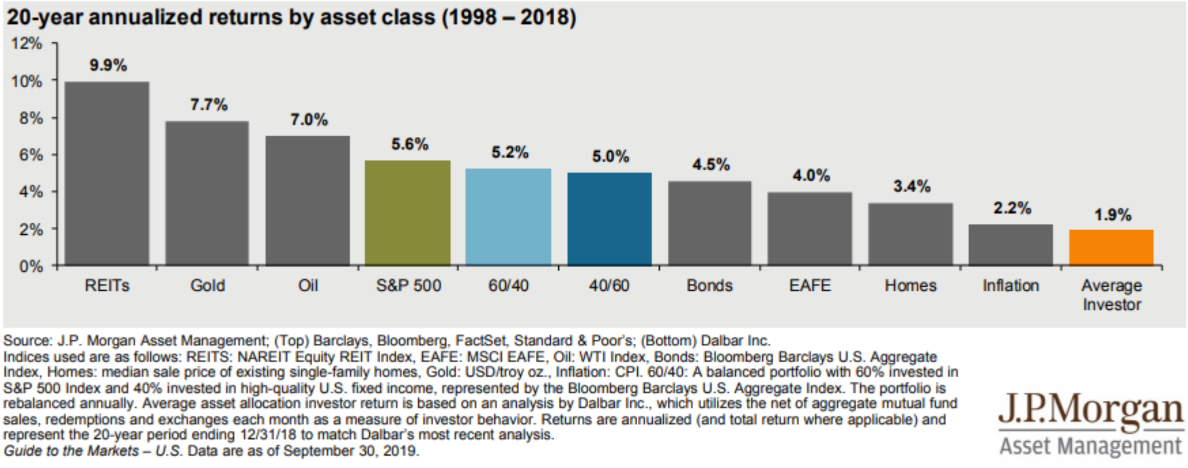
Focusing on businesses instead of stocks sounds like a simple concept, but as it is the case with most simple concepts, it is usually difficult to adhere to them. So, let’s start learning how to stick to simple concepts that will deliver wealth over the long-term.

Why do we focus on stock prices and not on fundamentals?

The reasons why the majority of investors focus on stock prices comes from our inherited wiring that evolved through a few million years of evolution. Up to just a while ago, the only thing we had to care about was to survive. As a human living 10,000 years ago, you would most likely survive if you carefully listened to the noises around you, ran away in panic if there was anything suspicious and by simply behaving as the rest of the herd. Those that ventured off by themselves were usually dead quickly.

We use the same brain, hard wired for natural survival, for our stock market investing decisions. So, if you can rewire your brain, not to listen to short term noise in the form of news or stock price action, if you can refrain from behaving like the herd, you suddenly find yourself at huge advantage when it comes to investing.

Further, focusing on fundamentals, understanding the business, requires effort and effort is another thing we have to force ourselves to give and do something. By looking at the stock price, we hope we understand what is going on. We think that all the available information is priced in and perhaps even get an effortless Nobel prize for the efficient market hypothesis. However, markets are not rational because humans make markets and humans are not rational. Perhaps the best illustration of why you should focus on investing and not on stock price speculation is what happens to the average investor represented in JP Morgan's chart. I think the chart speaks for itself. The average investor, that usually buys high due to fear of missing out and sells low because of panic, achieved an average return of 1.9% over the last 20 years. Everything else did better…



Source: JP Morgan

To become are real investor, you have to forget about stock prices and invest in businesses.

Stock price action and investing

"Forget about the word stock" said Warren Buffett at the Berkshire annual shareholder meeting in 2008. What did he mean by that?

Well, he meant that businesses are what delivers return, not the stock market and that by focusing on the stock market, you might divert your focus from what is really important.

Let's take Google as an example and try to put it into Buffett's perspective. Imagine you were listening to Warren at the Berkshire 2008 conference in May. You just Googled about it, found a video on YouTube and enjoyed the talk. Buffett convinced you that all you need to find is a good business and you will become a great investor.

Then, you thought how Google is a great business and that you will invest in it. You took your hard-earned money, let's say $100,000 and put it all into Google stock at $286.

Just 7 months later, you would look at your brokerage account and see it at $50,000. $50,000 just went into smoke.

Newspapers were full of articles about how everybody is selling and how you should not buy stocks.

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Slow-Motion Crash Leaves Investors Scrambling

By Ianthe Jeanne Dugan, Annelena Lobb and Neil Shah
Updated Oct. 13, 2008 12:01 am ET

The vertiginous stock-market ride of the past two weeks has left investors from the skyscrapers of New York to the kitchen tables of California struggling with whether to hold, sell or, somewhat improbably, buy.

The scenes from the front lines of the carnage looked like this:

In a Manhattan high-rise, hedge-fund manager Peter Siris watched in shock as "no" votes cascaded from the House of Representatives on Sept. 29. Lawmakers were rejecting the financial bailout. Soon, he was purging vulnerable stocks.

In Berkeley, Calif., Yue Cathy Chang, a 28-year-old IBM software saleswoman, peeked at her portfolio that evening. "Oh, no," she told her husband before calling their investment adviser, Paul Quinn, who was already moving to sell several of their stocks.

Source: WSJ

I am using the 2008 situation to try to put you into that unpredictable perspective. Who could had imagined that Google stock could fall 50% over 6 months? But it happened and it will happen again in the future. The key question to answer is: what are you going to do about it?

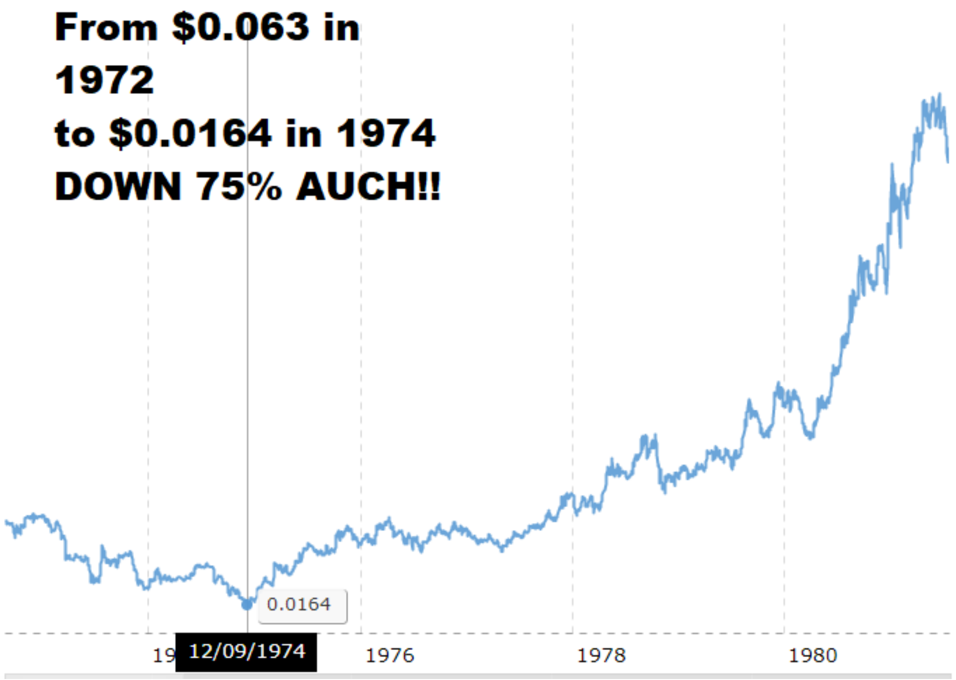
What most investors did, is they sold their stocks. I've spoken to so many investors and as it is me, I don't know why, they silently tell me how they sold in September of 2008, October, December and many really capitulated in March of 2009.

It is very hard for a human being to watch half of your portfolio simply go into smoke because everybody is talking about stock prices, not businesses. Even when CNBC interviews Warren Buffett, they constantly show short term stock market price action. (yearly and daily in the below case). This is absolutely crazy!

Source: [YouTube]

However, while most people were Googling about crashes and bailouts, Google the business was doing fine and that was subsequently reflected in the stock price. The $100,000 invested at first are now $471,000.

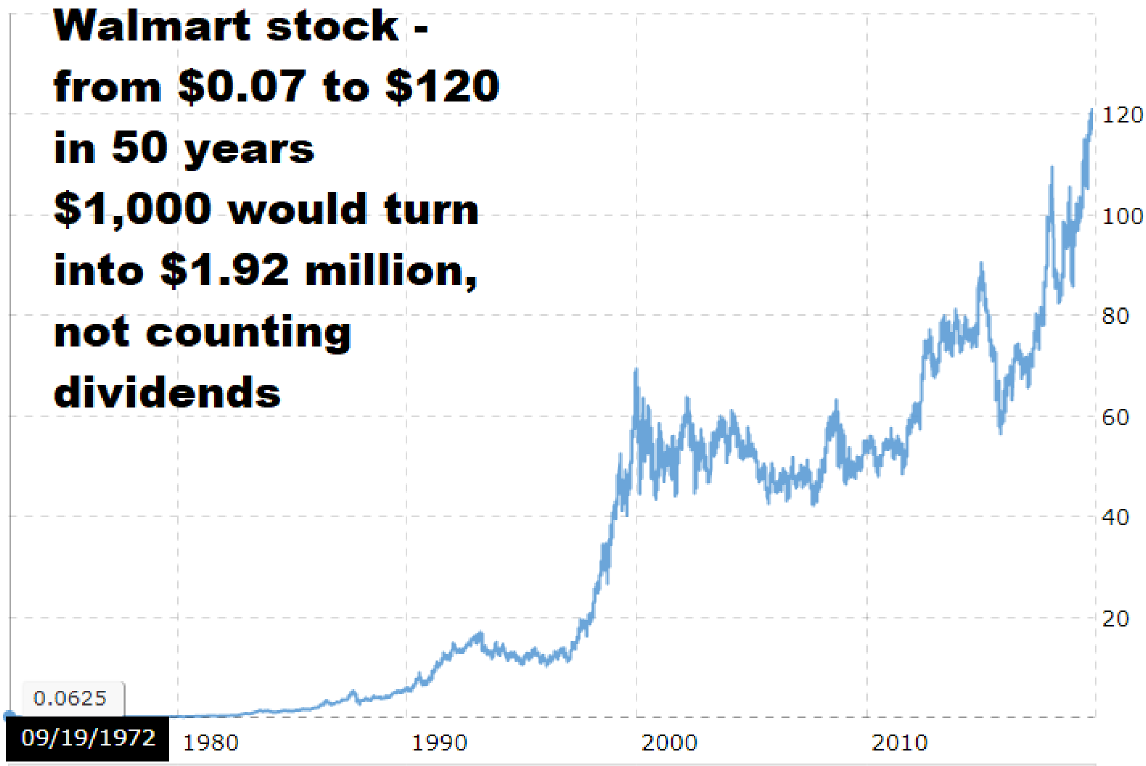
I have an even better example; I recently did a video on Small Cap Stocks and one example I used was Walmart. Walmart's stock fell from $0.063 to $0.016 in less than two years from 1972 to 1974.



Source: Macrotrends – WMT stock price

Imagine someone telling you that WMT stock should be the best investment in your lifetime and that you should put $10,000 in it in 1972 and two years later you were left with just $2,500? Would you still love that person or you would be a bit angry? Many would be angry and sell in panic in order to avoid not losing even more.

However, imagine the pain you would have now if you sold in 1974 because your $10,000 invested in 1972 would now be $19.2 million, not including dividends.



So, the next time you see your stock fall, be sure to ask yourself whether you are investing in a business or in the stock.

Sticking to Walmart and investing in busiensses, its numbers were simply staggering during the first years of the 1970. Despite that, the stock price fell 75%.

WAL-MART STORES, INC.

FINANCIAL HIGHLIGHTS

	1974	1973	Percent Change
Current Assets	**$45,254,112**	$32,787,057	+ 38.02
Current Liabilities	**$18,121,532**	$15,990,160	+ 13.33
Working Capital	**$27,132,580**	$16,796,897	+ 61.53
Current Ratio	**2.50**	2.05	
Stockholders' Equity	**$30,734,128**	$24,753,623	
Number of Shares Outstanding	**6,542,250**	6,512,950	

FIVE YEAR PROGRESS REPORT

	1970	1971	1972	1973	1974
Net Sales	$30,862,659	$44,286,012	$78,014,164	$124,889,141	**$167,560,892**
Income before income taxes	$ 2,198,764	$ 3,170,599	$ 5,569,027	$ 8,917,188	**$ 11,883,754**
Pro forma net income	$ 1,187,764	$ 1,651,599	$ 2,907,354	$ 4,591,469	**$ 6,158,520**
Pro forma net income per share	$.23	$.30	$.47	$.70	**$.93**
Number of stores in operation at the end of the period	32	38	51	64	**78***

**Two Ben Franklin variety stores were sold and four were closed during the year.*

Source: WMT

Walmart's business kept growing, earnings were up, the number of stores was growing, but the stock price went down. And this is probably the best lesson one can get about investing in stocks or investing in businesses. Stocks go up and down because markets are irrational, what we have to do is to focus on owning businesses across economic and stock market cycles.

3 steps how to keep your focus on what matters

When it comes to investing, you can rewire your brain. Think about how will the current situation or the last few bits of information you got from looking at stock prices affect your well-being in 10 or 20 years. It probably won't. But, 3 things that will affect your wellbeing in a decade or two are the following:

1) What and why you have bought something

If you are investing in businesses, then you care about what are the assets you bought, the profitability, long-term growth aspects, cash flow projections and business quality. You don't really care about stock prices. Focusing on something before buying, getting to know it really well, is the key thing that will save you from selling at the wrong moment in time.

2) How much are you going to buy of something

We have seen how even Google stock can fall 50% at any moment in time. Thus, it is always up to you to decide how much to buy something and

3) At what price you buy

Here come fundamentals in play, the most important thing to focus on and confront to stock prices. You need to understand the long-term fundamentals of a business. Understanding the long-term fundamentals of a business is key when it comes to investing as long-term business fundamentals withstand crises, crashes, recessions, presidents and all other things that can hit the stock market. You need to be able to estimate the future cash flows the business might return to you. When you can do that, you compare the present value to the current stock market price and then you are an investor. All the rest is speculation.

This is what I do, I am not saying it is easy, but I try to focus on businesses and look beyond stock price action. If you wish to check my portfolio, check my Stock Market Research Platform.

If you wish to learn more about investing, check my FREE Comprehensive Stock Market Investing Course.