Trust your own common sense

Why are markets difficult to understand? Our minds are attuned to Newtonian physics: for every action there is a corresponding reaction. However, in stock markets, that doesn't always happen. Take the case of the announcement of inflation figures on Fridays in recent weeks. Although inflation is going up, the markets are also going up, only to fall back after a couple of days. You'd think they would fall when the news comes in, but generally, the opposite happens. People react without thinking. They react on emotion, and this emotion changes very fast when they see the markets rising or falling. People are guided by the short-term moments of the markets. In such times, if one knows the news is bad, one must resist the temptation to enter the market. However, most people question their own intellect when they see markets going up, and start buying in the hope that others know better. This self-doubt leads to financial blunders. Having faith in one's own common sense is very important.

penny wise
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Another important thing to understand is that stock markets are not a zero sum game. We often believe if someone wins, someone must lose. Let's say three friends, Rajesh, John and Jagdish, each hold 100 shares of Reliance. Rajesh sells his 100 shares to Jagdish at Rs 2,400. After a week, the price drops to Rs 2,200. Rajesh is lucky. He stands to earn Rs 20,000: he can buy back the same shares for less. Poor Jagdish has lost Rs 20,000, as the value of his investment has depreciated. Our minds, attuned as they are to physics, understand the market in this action-reaction paradigm. But what about John, who did nothing? John is also poorer by Rs 20,000, although he made no transaction. He faced a reaction without acting. This is what makes stock markets hard to understand. Even when you do nothing, you are subjected to the whims and fancies of the crowd. So your decisions could be waylaid through no fault of your own. Not being swayed by the market movements, but rather using them to your advantage, is the key to success in investing.

Newspapers often report rankings of the richest people in terms of market capitalisation. Is this right? Market cap changes with every change in sentiment. This creates competition amongst corporates. They go to any lengths to reach the top spot. It's envy at work. When managements compete in the market cap game, they provide wise investors the opportunity to exit and count their profits. Reflect on the last six months. Real estate, telecom and power companies provided such opportunities. Envy was ruling. Each wanted to be bigger than the other. Various corporate announcements took stock prices higher, along with market capitalisation. Newspapers reported winners and losers, serving only to further vitiate the envious environment. The buck stopped, and stocks fell. This also changed the richness rankings. Stock markets are interesting because they are inefficient and difficult to understand. And that has created a huge financial industry that benefits from this mystery.

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