

Arne Alsin: Pitfalls that await the emotionally motivated ‘blind investor’

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Charlie Munger was asked a few years ago to explain how he achieved his amazing success in the stock market. He thought for a second, and then replied simply: “I’m rational.”

Implicit in Munger’s reply is that other investors are prone to bouts of irrationality. A rational investor, such as Munger, has an edge if other investors make decisions that are subjective, impulsive or emotion-based.

To understand better what it takes to be such an investor, here are three core concepts that every rational investor understands and embraces. If you invest your capital in contravention to any one of these concepts, you are not a rational investor.

The decision-making process focuses on a comparison of price and value

Before making an investment decision, the rational investor requires answers to two simple questions: “What’s it cost?” and “What’s it worth?”

The first question is easy to answer. The second question is difficult to answer, sometimes exceedingly difficult. Regardless, a rational investor will not allocate capital unless both questions can be answered with a reasonable level of confidence.

In other asset classes, the nexus for decision-making always revolves around a comparison of price and an appraisal of value. For example, a rational person is not going to sell a car valued at \$20,000 for \$10,000. This sort of irrationality does not happen with cars. But it happens every day in the stock market.

Many investors are, in effect, “blind investors” because they make buy and sell decisions without knowing value. You are a blind investor, for example, if you buy the stock of a company because you like its products, or because the company has impressive growth prospects.

These are reasons to become interested in a company. But they are not sufficient reasons to buy the stock. The stock might be overvalued by 50 per cent or more. Without an understanding of both price and value, an investor cannot make an informed, rational investment decision.

The purpose of the stock market is to facilitate liquidity

Many investors misunderstand the purpose of the stock market and this leads to irrational decision-making. Its purpose is to provide a venue for buyers to acquire ownership in publicly traded businesses and for owners (investors as well as companies trying to raise capital) to sell those interests.

The market is amazingly efficient in this regard. There is always a ready bid and there is always a ready offer. It just takes a second or two to acquire or sell a part-ownership interest in a publicly traded business.

But that is as far as it goes. The market tells you price. The market does not tell you value. To ask the market to facilitate the trading of business ownership and, in addition, to value those businesses accurately is asking too much.

When investors see one of their stocks drop by 20 per cent, they get upset because they think they have lost money. But all that has happened, in reality, is that the current offer for their asset has declined by 20 per cent. The value may have not declined at all. It is entirely possible that it has increased.

The owner of a private business does not get upset if he gets a lousy offer for his business. Even if the private business owner actively solicits offers, he does not expect to get a full value offer each and every day. The rational owner of a business, whether it is a private business or a publicly traded business, knows that full value offers occur infrequently.

Price and risk generally move in tandem

Most investors misunderstand risk as it applies to the stock market. Most do not understand that, generally, as price declines, risk declines. If the price quote for a stock worth \$100 falls from \$80 to \$60, the risk of buying or owning that stock has declined in concert with the price.

When value exceeds price, risk declines when value subsequently increases and/or price decreases. And when value exceeds price, risk escalates when value subsequently decreases and/or price increases.

When irrational investors think about risk, they focus only on price. Price is everything to such investors. The fact that they are not carefully comparing price and value creates an analytical void. Emotions usually fill that void.

Higher prices create enthusiasm and an increased interest in buying. Falling prices cause worry, but there is a way for the irrational investor to alleviate the worry: sell everything!

Ironically, irrational investors tend to worry most when they should be worrying the least - when value exceeds price by a wide margin. And they tend to worry least when they should worry the most: when value exceeds price by a narrow margin, or, worse, when prices exceed value.

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