

Arne Alsin: Two simple questions that protect against the siren's Print song

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A vast amount of intellectual energy is devoted to investing in the stock market. Much of that energy is misallocated. That is because many investors waste time pursuing answers to the wrong questions.

All great investors, from Warren Buffett to Peter Lynch to Michael Price, understand a single, fundamental premise. That is, in order to be a successful investor you have to be able to answer two simple questions: "What does it cost?" and "What is it worth?"

Investors often answer the first question and stop there. They buy a stock at the current quote (the cost) because of a tip from a friend. Or they buy a stock because they hear it touted on television. Others will buy a stock because they like the company and its products.

Answers to the two simple questions are meaningful only if both questions are answered. If investors don't answer the second question, "What is it worth?", the answer to the first question is meaningless.

By itself, the fact that the cost of a stock is \$50 a share is meaningless information. Is the stock worth \$10 a share? Is it worth \$100? Only when you answer both questions will the answers have meaning.

Before making a buy or sell decision, great investors allocate most of their time and energy to answering the two simple questions. That is not the case with many other investors, however. Investors get sidetracked. They waste time and energy when they consider the wrong things. Here are three examples:

- **Technical analysis:** Among amateur investors, technical analysis is a popular tool for making buy and sell decisions. Nevertheless, I'll be blunt. Technical analysis is a complete waste of time. Private business owners do not employ technical analysis to figure out how or when to buy or sell. Just because a business has shares that are publicly owned does not change the investing equation. You still need answers to the two simple questions.

At its base level, technical analysis preys on the human tendency to look for patterns, even in the midst of randomness. In one study comparing human beings and rats, a green light flashed randomly 80 per cent of the time and a red light flashed randomly 20 per cent of the time. Because of the preponderance of green flashing lights, the rats selected the green light every time, to get a food reward. As a result, the rats were right 80 per cent of the time.

The human test subjects, though, perceived patterns where none existed. For example, if the green light flashed twice and then the red light once, they would tend to predict a repeat of the pattern. The net result was that the humans trailed the rats, selecting the correct light only 67 per cent of the time.

It is no wonder that not a single mutual fund, hedge fund or acclaimed investor has achieved an impressive long-term record using technical analysis. The reason is that technical analysis fails to answer the question: "What is it worth?" Advocates of technical analysis say you don't need to know what an asset is worth. By implication, then, a fan of technical analysis says it is rational to pay \$50 for an asset that's worth only \$10, or to sell a \$50 asset for \$10, as long as the charts say so.

- **Short selling:** It is a waste to spend your time researching stocks to sell short. Not a single dedicated short-seller has exceeded the market's return over the long term. In fact, nary a short-seller can boast of achieving a rate of return that matches the return from treasury bills.

Short-selling may appeal to investors who can answer the two simple questions. If a stock is priced at \$50 a share, for example, and you correctly calculate that the stock is worth only \$30, you may think it makes sense to short the stock. The problem is that a stock can stay overvalued for years while carrying costs accumulate. There is the risk that an overvalued stock might get even more overvalued. There is also the risk that overvaluation may disappear if the business value increases.

If you are convinced that the market is headed lower, you will save both time and capital by ignoring the temptation to short. Buy a T-bill instead.

- **Forecasting:** Do you spend any time thinking about the direction of the economy, whether interest rates will

rise or fall, or whether we are in a bull or bear market?

If so, you are wasting your time and energy. There is not a single forecaster, now or in the past, who has consistently predicted the economy or the stock market. Even the smartest, most capable and highly trained experts have failed miserably.

Let others waste their time in a futile attempt to predict the unpredictable. Here is all you need to know. Good and bad cycles come and go. There is no net impact for long-term investors, because they cancel each other out.

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