



Investment Insights

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Psychology and Investing: Fear and Greed

Why does the stock market jump up 100 points one day, only to fall 100 the next? Why is it that a company can report “good” earnings, only to drop 10% in value the next day? Much of this relates to the short-term psychology of the market, where investors can be “disappointed” with earnings, “excited” about a company’s prospects, or “worried” about foreign events. Emotions and psychology play an important short-term role in all markets. Excessive optimism can drive valuations to extreme highs, just as rampant pessimism can cause extreme lows. Over the long-term, the market is driven by earnings, the economy, interest rates, and other fundamentals but in the short-run many investing professionals say the market is driven by two emotions: fear and greed. Predicting and measuring the psychology of the market is nearly impossible. Understanding how current psychology is influencing the market can be very valuable in making you a successful investor.

During my career, I’ve experienced a few periods where market psychology reached extreme level. The recent bull market in technology stocks that ended in 2000 was one of the most excessive cases of optimism and greed ever. Many investors felt technology stocks could never decline, and the fear of missing out on making money was greater than the fear of possibly losing money in a decline. Some investors borrowed money, drew equity out of their homes, or cashed in all of their CD’s and bonds to jump into this “can’t miss” opportunity. Ridiculous valuations, lack of earnings or dividends, no sound business strategy: none of this mattered, things were going up, and the end was nowhere in sight.

Of course, we all know how that finished. The NASDAQ Composite Index, which is a good measure of the technology sector of the market, currently sits 64% below its high reached in March of 2000, a mere two years ago.

Here is something to consider. Today, I hear many of the same arguments I heard back in 2000. “Prices can’t go down!” also “I have to get in now!” The difference is that now they are talking about the housing market, where the current “can’t miss” opportunity exists. Investors borrow as much money as they can afford, offer bids well above what

the seller believes is a fair value, and valuations soar to unheard-of levels. Will the housing market suffer the same fate as the NASDAQ market? Only time will tell.

One lesson is clear. Do not blindly follow the crowd. When an investment is considered a “sure thing”, the reality is often the opposite. In fact, many successful investors are “contrarian,” meaning they do the reverse of what the crowd is doing. As the famous investor Warren Buffett once said, “Buy when everyone else is selling, and sell when everyone else is buying.”

It is important to remember that, although excessive optimism can create dangerously inflated values, excessive pessimism can create incredibly cheap bargains. Look for value in investments that have fallen out of favor, and do your homework on these opportunities. For example, despite all of the negative talk and pessimism surrounding the stock market lately, over the past 12 months ending 3/31/02 the Russell 2000 Index of small-company stocks gained nearly 14%!

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