

# FUNDAMENTALS + INVESTOR PERCEPTION = MARKET MOVEMENT

How to Avoid the Mistakes of the Losing Majority



BY SACHA TARKOVSKY

# The Power of Contrary Thinking

*“Take calculated risks, that is quite different from being rash”*

George Patton

Following the trend is an accepted way of making money from trading. Trends persist and if we can lock into and hold them they can yield us great long-term profits. There is however, a lot of money to be made by spotting trend changes. It is at these turning points where we can trade with the best risk / rewards. Spotting them is easy when you know what to look for.

The key to spotting these trend changes is the reaction of traders themselves. Contrary Trading is based upon a constantly recurring phenomenon, which has remained constant for thousands of years - Human Nature. All you need to do is to study the response of traders to price action. You can then be trading in the opposite direction to the uninformed herd and know that you have a high probability of being right. You now have the opportunity of joining the minority of informed traders who make substantial profits from trend changes.

## II. HOW INVESTORS DETERMINE PRICE

*“There are in the fields of economics no consistent relations and consequently no measurement is possible.”*

Ludwig Elder Van Mises

Many investors believe that price is determined by a simple tug of war between supply and demand factors. They feel that the fundamental study of this area is all that is needed. For example, in financial markets the fundamentalist will look at corporate earnings, interest rates, changes in money supply, and many others. In agricultural markets such factors as planted acreage, crop reports, weather considerations and transport would be important. However, as B. Pugh states:

*“All the crop news and political events will be of little use. If it were possible to trade successfully by good and bad weather conditions, it would be unbelievably easy to make money when the news filters through ten or twenty thousand minds interested in wheat. The major opinion may be quite different from the opinion of an individual.”*

Let's define exactly what a futures market is. It is in effect an area to bring buyers and sellers together and facilitate trade. A futures market does not exist to ration supply and demand, nor to allocate resources, but simply to facilitate trade. It is a perfect example of the free enterprise system at work.

“By nature men are nearly alike, by practice they get wide apart.”

Confucius - The Confucius Analects

It is the market participants that ultimately determine the price of a commodity. There is no scientific theory or formula that determines what the price of anything should be. The facts and statistics are there for all to see. However, people's opinions on the statistics vary. All of us make personal, subjective, emotional judgements, along with all the participants that ultimately determine price. Our decisions are affected by our emotions. We can all be logical and rational, and it is this side of our nature that has allowed us to advance in such areas as medicine, communications and computer technology. However, we are fundamentally emotional beings; this is an innate part of our nature, and we are subject to a variety of moods including hope, despair, euphoria, greed, fear, optimism, pessimism and many more.

If you want a graphic example of how humans determine price, think of what happens when you exchange a worthless piece of paper for a variety of goods. Money relies on a shared consensus for its value, which would disappear if the consensus evaporated.

*“Men at some time are masters of their fates, the fault dear Brutus is not in our stars but in ourselves, that we are the underlings”.*

William Shakespeare - Julius Caesar

There is one statistic that has remained constant in investment since records were kept - and that is the ratio of winners to losers has remained constant over time. On reflection this would seem a startling fact, but despite the massive advance in economic forecasting methods and supply of information, the ratio remains the same. Being in touch with all the market news will not, as B. Pugh pointed out, put your investments in the plus column. The obvious conclusion to be drawn is that success in the market is dependent on something else. That something else is emotionalism and how it affects our personality when we invest. It is our emotional make up that is the weak link in the investment process.

*“We cannot escape it (emotion). In the future it will cause another panic in Stocks. When it comes, both traders and investors will sell Stocks, as usual, after it is too late, or in the latter stages of a bear market.”*

W.D. Gann (1949)

It is emotion that causes the majority of investors to be wrong at critically important turning points - to quote Gann again:

*“Therefore, in order to make a success, the trader must act in a way to overcome the weak points that have caused the ruin of others.”*

### III. PANIC, MANIA & HUMAN NATURE

*“Never underestimate the power of human stupidity”.*

R.A. Heinlein

There are many who believe that yesterday’s markets were different to those of today. The facts, however, illustrate that markets today are just as influenced today by human emotion as they ever were. I want to now illustrate the effect of emotion on traders with specific examples, and then analyse the lessons that we can learn. By seeing how the vast majority lose, we can hopefully step aside from the crowd and enter the elite minority who profit consistently from the markets.

*“Much has been written about panics and manias...but one thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money... the money of these people, the blind capital as we call it, of the country is particularly large and craving; it seeks someone to devour it, and there is plethora, it finds someone, and there is speculation, it is devoured and there is panic.”*

Walter Bagehot - Essay on Edward Gibbon

In looking at the effect of emotions on the investing public, an excellent place to start is with Charles Mackay’s delightful book “Extraordinary Popular Delusions and Madness of Crowds” published in 1841. MacKay covers three manias we all remember from school, The Tulip Mania, The Mississippi Madness and The South Sea Bubble.

#### Tulip Mania

One of the most famous manias in history occurred in Holland in the 1500s when tulips were introduced, and by 1634 they were an important fashion/ status symbol. By the time the mania had reached its height in 1636 a single bulb cost 5000 Florins or, in today’s prices, in excess of \$20,000!

*“At first, as in all gambling manias, confidence was at its height, and everybody gained. The tulip jobbers speculated in the rise and fall of tulip stocks, and made large profits by buying when prices fell and selling when they rose. Many individuals grew suddenly rich; gold bait hung temptingly out before the people, and one after the other rushed to the tulip marts like flies around a honey pot. Everyone imagined that the passion for tulips would last forever, and that the wealthy from every part of the world would send to Holland and pay whatever the price was asked for them. Homes and land were offered at ruinously low prices or assigned in payment of bargains made at the tulip mart. At last, however, the more prudent began to see that this folly could not last forever. Rich people no longer bought the flowers to sell them again at a cent per cent profit. It was seen that somebody must lose fearfully in the end and, as conviction spread, prices fell and never rose again.”*

Charles Mackay

The market value of tulip bulbs declined by over 90%, and the economy of Holland lay in ruins. MacKay concluded:

*“Many, who for a brief season, had emerged from the humbler walks of life, were cast back into their original obscurity. Substantial merchants were reduced almost to beggary, and many a representative of a noble line saw the fortunes of his house ruined beyond redemption.”*

The above has very little to do with supply and demand. The trading was emotionally generated with greed and fear to the forefront.

## Mississippi Madness

A century after the tulip mania in Holland, it was France's turn to experience a speculative mania. John Law, a Scotsman, who had killed his lady friend's lover and fled to France, perpetrated this one. A gambler by nature, he set in motion a speculative boom that became known as the Mississippi Madness.

In 1716 Law persuaded the Prince Regent to allow him to set up a bank, and then got the Regent's consent to turn the bank into a Government institution. Law then simply manufactured money, (it should have been backed with precious metals). The abundance of money flowing into the economy saw interest rates fall, and industry boomed.

In 1717 the Crown granted Law's Mississippi Company the exclusive rights to trade up and down the Mississippi river. At the time, it was believed the area was awash with precious metals.

The scheme caught the public's imagination immediately, and Law promised investors an incredible return, (with no substantiation whatsoever). Shareholders were promised a return of 120% annual yield on dividends alone. Mackay writes:

*“The public enthusiasm, which had been so long rising, could not resist a vision so splendid.”*

The initial stock offering was at 400 livres in 1716 and, so frenzied was the buying, that by 1720 the stock had appreciated 40 times from the original price. Investors created a speculative bubble, inflation increased and prices spiralled by 300% as successful speculators spent their paper profits. Mackay observed:

*“The looms of the country worked with unusual activity to supply rich laces, silks, broad cloths and velvet which, being paid for in abundant paper, increased in price... new homes were built in every direction, an illusory prosperity shone over the land, and so dazzled the*

*eyes of the whole nation, that none could see the dark cloud on the horizon announcing the storm that was too rapidly approaching.”*

A leading nobleman, the Prince De Conti, started the confidence collapse in Law's grand scheme by taking three wagons of paper money to the bank and demanding payment in (specie) metal. The bubble burst as people realised they were holding worthless paper. A run on the bank occurred, and the price of Mississippi stock crashed. Shares that had soared from 500 livres in 1716 to 20,000 in 1720, plunged to 200 livres, a 99% loss. Just as the economy of Holland was devastated, so too now was the economy of France.

## **The South Sea Bubble**

On the other side of the Channel, another mania was about to unfold. Robert Harley formed the South Sea Company in 1711. The company was granted a monopoly by the Government of the day to trade with South America and the South Sea Islands. The volume of trade was unlikely to be substantial as Spain ruled most of the area and large trade, without her consent, was unlikely. However, this did not dampen enthusiasm for the company. Harley offered to absorb the national debt of over 30 million by issuing South Sea stock to bondholders. The bill passed through Parliament, and prices skyrocketed from £128½ per share in January 1720 to £1000 in August. Mackay recounts the excitement of the day:

*“It seemed, at the time, as if the whole nation had turned stockbrokers. Exchange Alley, (a street in the City of London), was every day blocked up by crowds and Cornhill was impassable for the number of carriages. Everybody came to purchase stock.”*

The bubble burst in 1720 when news that the directors had been selling stock, and panic ensued. Shares plunged from £1000 to only £135, an 87% decline.

The mood at the time of the South Sea bubble fostered a rash of some of the most preposterous schemes imaginable that gripped the public's imagination. There was, for instance, a high subscription for a company that was to manufacture a perpetual motion wheel, and another for 'trading in hair.' The most ridiculous of all was perhaps a company that was formed, according to Mackay "For carrying on an undertaking of great advantage, but nobody is to know what it is."

For every £2 invested, subscribers would be entitled to a dividend of £100. This unsubstantiated promise yielded £2000 within five hours. Having made his money, Mackay commented that the promoter "was philosopher enough to be contented with his venture, and set off the same evening for the Continent. He was never heard of again."

*“Those who cannot remember the past are condemned to repeat it.”*

G. Santayana

Many people would argue that we have become more sophisticated in the twentieth century. However, the fact remains that there is no difference in the crowd psychology that became enmeshed in tulips, as today manias only differ in the degree of madness. R.E. Band, in his excellent book “Contrary Investing” illustrates the point with a company that set up in 1983 with the following in its prospectus:

*“This offering is of securities of a start up company with no operating history and no plan of operation. The company will not engage in any business whatever until after completion of this offering and the company does not know what business it will engage in, and has no plan of operation.”*

The wording was perhaps inspired by Mackay’s eighteenth century entrepreneur. Did it raise money? Amazingly \$3 million!

## **The MMM Fiasco: A Russian South Sea Bubble**

The company MMM has recently become Russia’s biggest share scandal and has been referred to as Russia’s South Sea Bubble.

The price of the stock rocketed as the company promised to pay up to 80% dividend on shares per month, or 960% annually! The promise, of course, was totally unsubstantiated by any explanation as to where the money would actually come from. The company reported no earnings, revealed no investments and explained no financial strategy. The price of shares reached 125,000 Roubles, around \$60, from a mere few hundred Roubles. The price was purely driven by new people buying shares. The demise of the company started with the repeated warnings from the Government, including President Yeltsin, and raids by Government officials for tax violations. A scramble to sell ensued and the price dropped to 950 Roubles, around 60 cents.

Mr Mavrod, MMM’s charismatic Chairman, claimed that:

*“We have been stopped on the eve of a super breakthrough after which Russia could have become the richest country in the world, and Russia’s MMM shareholders were wealthy people.”*

How many people believed Mr. Mavrod’s empty rhetoric? The estimated figure of shareholders was disputed. Government estimates were 2.5 million, and MMM’s estimate 10 million. Whichever figure was correct, the amount of investors was considerably bigger than the Russian army and, just like the South Sea Bubble it has been compared to, investors came from all walks of life and included many Government officials.

Examples of emotionally generated trading are common throughout the twentieth century. We have the Florida land boom of the 1920s, the UK property market in the 1980s, the Silver speculators in 1980 and, of course, two major stock market crashes in 1929 and 1987.

The two emotions that come to the forefront are greed and fear. A bull market starts in a climate of fear. As the market gradually makes headway, fear recedes and confidence appears as prices move higher. Finally, as prices reach a cyclical peak, euphoria and greed take over, and there is a consensus that the rise will continue indefinitely. On the way down the same emotions predominate, but in reverse order. The emotions of greed and fear are the ruin of the majority of investors.

*“The crowd madneses recur so frequently in human history that they must reflect some deeply routed trait of human nature...If this book showed how baseless are man’s moods of wild hope (greed), it also showed that man’s moods of black despair (fear) are equally unfounded. Always in the past, no matter how black the outlook, things got better...whenever men attempt they seem driven to try and overdo.”*

B. Pugh

## IV. CONTRARY OPINION

*“The fact that an opinion has been widely held is no evidence that it is not entirely absurd; indeed, in view of the silliness of the majority of mankind, a widespread belief is more likely to be foolish than sensible.”*

Bertrand Russell

So why does the crowd always get it wrong? The majority lose because most investors are followers, not leaders. Investors wait until they see other people buying, and they wait until they see other people selling. As a result, most people buy after prices have already risen and sell after prices have already fallen. By chasing the crowd, the typical investor loses twice over, he buys too high and sells too low.

When people get caught up in a crowd, they stop thinking rationally and allow themselves to be governed almost entirely by emotions. This state of mind prevails at almost all market tops and bottoms. During these moments of mass delusion, the crowd extrapolates the current trend too far. As Humphrey Neil point out:

*“A crowd never reasons but follows its emotions, it accepts without proof what is suggested or asserted.”*

The long-term component of market prices becomes grossly, irrationally exaggerated. Ultimately economic reality takes hold and prices return to more realistic levels. In the interim, however, the lunatics have taken over the asylum.

*“When everyone thinks alike, everyone is likely to be wrong.”*

Humphrey Neil

Consider the following: investors buy because they expect the market to go up, and they sell because they expect the market to go down. However, if everyone in the market place is looking to go up (a consensus), the consensus that everyone who is going to buy has already bought, so who is left to bid prices up? The same obviously applies in a falling market. In a free market you will never get a 100% agreement, however, the closer it is to a consensus the more likely the majority is badly mistaken.

When a virtually unanimous, emotionally charged majority appears, it is almost certain to be wrong. An important point to remember is contrarians do not argue the majority is wrong. The majority is often right about long-term primary trends all contrarians argue is that the crowd suffers, mass delusions and extrapolates the trend too far. As Humphrey Neil says to the question “Is the public always wrong?”

*“The answer is decidedly no. The public is right more times than not. In stock market parlance, the public is right during the trends and wrong at both ends.”*

It is at both ends we will use the theory of contrary opinion to enter the market for maximum profitability.

## **V. THE MADDING CROWD**

*“When people are free to do as they please, they usually imitate each other.”*

E. Hoffer

In this chapter I want to dwell on human personality and why we end up following the crowd, and how our emotions affect us. It is quite clear from what has just been written that the bulk of investors need to change their behaviour. In order to change investor behaviour, we must observe how it develops and how we can change it.

If you consistently buy into fear and sell into greed, you will make money. It sounds incredibly easy. What has already been said will probably strike you as logical; however, in practice people find it incredibly difficult to do. We are all susceptible to the influence of the crowd. In fact, in normal, everyday life, being part of a crowd is seen as being totally normal. In 1890 Gustav Le Bon wrote a brilliant book that is essential for any investor to read “The Crowd, A Study of the Popular Mind”. In crowd psychology, a “crowd” has different

characteristics from individuals. Individuality becomes lost, as it were, and a collective mind is formed. Le Bon states that a gathering that becomes an organised crowd “forms a single being and is subjected to the law of mental unity of crowds,” and a “crowd is at the mercy of external exciting causes and reflects their incessant variations. It is the slave of the impulses which it receives”. Le Bon is making an important point in that the mind of the crowd often reflects the behaviour of the lowest common denominator in the crowd. Therefore, crowds do not exhibit highly intelligent behaviour. The person then who is capable of individual thought has a tremendous advantage. As Humphrey Neil points out:

*“A crowd never reasons, but follows its emotions; it accepts without proof what is suggested or asserted.”*

A crowd basically exhibits the worst type of behaviour possible when investing, combining high emotion with little or no independent thought. We, however, on many occasions embrace the views of the crowd because it is quite normal within society.

*“I sometimes think that speculation must be an unnatural sort of business, because I find the average speculator has arrayed against him his own nature. The weaknesses that all men are prone to are fatal to success in speculation - usually those very weaknesses that make him likable to his fellows or that he himself particularly guards against is those other ventures of his where they are not nearly so dangerous as when he is trading in stocks or commodities. The speculator’s chief enemies are always boring from within.”*

Edwin Le Fevre - Reminiscences of a stock Operator

Trading can be difficult and confusing because some of the character traits and impulses considered normal in society may tend to be the opposite of what is required in trading. This does not imply that trading is immoral or antisocial, but requires a different approach. In his book “Instincts of the herd in peace and war”, W. Trotter asserts that man is essentially a social animal; he is gregarious, which comes from the Latin word for flock. He is essentially intolerant of solicitude. He is more influenced by the herd than any other influences. He is subject to the passions of the pack, he is remarkably susceptible to leadership, and his relations with his fellows are dependent upon recognition of him as a member of the herd.

*“Our political, religious, business and educational institutions tend to perpetuate people having blinders on - the narrowing of minds rather than the broadening of them.”*

P. Macready

Many of our modern day responses can be traced back to prehistoric times. Our security and existence was dependent upon binding together in groups. This coming together of groups is therefore natural to the human race. The structure of society again reinforces this. Most societies have rules and laws within their structure that people are taught to obey. Man’s natural sociable nature and fear of loneliness or isolation also make him seek the company of

others; the family unit being an obvious example. You may say that in Western society we have free thought. We do in certain areas, but there is still considerable control - obvious like laws, and less obvious like the media and modern advertising. To a degree man's individuality of thought, which is essential to success in investing, is restricted by his own emotional make-up and structure of society.

Perhaps the perfect example of how keen people are to follow each other rather than stand-alone was a well known psychology experiment undertaken at a famous American University.

The experiment was to look at the effects of negative reinforcement on learning. Students were to administer small electric shocks to fellow pupils when they failed to answer questions correctly. The idea was to increase the voltage to see if learning speed could be quickened by administering shocks with progressively higher voltages.

The student taking the shock was actually an actor and there was no physical danger. However, the students' keenness in this experiment is extremely interesting. At the start of the test, the Professor in charge announced that he would take full responsibility for the test. The students' keenness to administer greater and greater shocks without question left the actor almost faking death. Interestingly, when one student suddenly announced he was no longer prepared to administer the shocks, due to the potential of a fatality, everyone else then refused as well.

This experiment graphically illustrates how eager humans are to confirm with the herd, and how they fail to question following an experiment that could actually lead to the death of one of their colleagues.

## **VI. INDIVIDUALITY - THE KEY TO SUCCESS**

*"We suffocate among people who think they are absolutely right, whether in their machines or in their ideas."*

Albert Camus - Neither Victims or Executioners

As we have seen, it is quite natural for humans to group together due to their sociable nature. In addition, the societies that man has created have reinforced this further. Today we are faced with a society that is becoming even more complex due to the technological advances of man. This extremely complex and specialised society has actually meant that we all tend to specialise in particular areas and delegate to someone else a task we feel we do not have sufficient time or expertise to concentrate on. For instance, if a computer breaks down we may well consult a specialist who we feel has the knowledge and experience to solve the problem. Similarly, those with money to invest give it blindly to the so-called experts of the financial world to invest for them, or follow some learned guru in the media. With the fixing

of a computer we have a logical problem with a logical solution, and there is a scientific formula to get the desired result. With finance, however, we have an area where logic by itself does not work, and there is no set formula that guarantees success, so just how good are the so-called experts, and could you do better?

*“An economist is an expert who will know tomorrow why the things he predicted yesterday, didn't happen today.”*

Dr. Lawrence J. Peter

If you study the statistics, you will find that the advice of the so-called experts is, on the whole, very poor. Financial experts who are in the media nearly always make their most wildly inaccurate predictions at, or close to, important market tops and bottoms. Remember October 1987 - how many were saying we were entering a “golden era” for shares, and how many stockbrokers' fund managers lost in the crash? If you look, you will find the bulk lost. As we have stated, all the fundamental data, news, computer technology and advanced communications, are not by themselves a recipe for success. Following the crowds is a psychological, not an intellectual, failing. Despite the gloss and propaganda of the experts, on the whole their long-term track records are poor.

The Wall Street Journal did an interesting competition in which several market experts were to use their skill and judgement to pick various shares. They then pitted them against “the monkey”, which effectively was a random throw of a dart at a board. After a period of several months, you won't be surprised to know the monkey was marginally ahead! There is no need to feel intimidated by the experts, you can compete against them on equal terms and you will find you beat them with regular consistency.

*“It follows the more specialised society becomes, the less attention it pays to the discoveries of the mind which are intuitively beamed towards the brain, there to be received only if the switches are ‘on’. Specialisation tends to shut off the wide band tuning and thus, to preclude further discovery of the all-powerful generalised principles”.*

B. Fuller - Synergetics

Independent thought is essential to success. Thinking for oneself is one of the highest privileges granted to mankind, but it is one that we use less and less in modern society. The age of specialisation means that we concentrate our thoughts in narrow areas we feel comfortable with. This has led to many investors feeling at a disadvantage against the so-called experts and their vast amount of data and sophisticated technology. After reading this you should feel comfortable that you can compete as an equal.

*“Whatever you do for the next five minutes, don't think of the colour blue.”*

Neurolinguistic Programming Paradox

The first thing a trader must do before entering the market is to understand our own nature. While we can never remove ourselves from the human race, we can deviate from the norm in certain areas by having a clear understanding of our strengths and weaknesses. Whilst we are all emotional beings, subject to the impulses of the crowd, we are however capable of individual thought and this will allow us to adapt and change if we wish to do so. The fact is, what can be learned can be unlearned. For instance, the investor who follows the crowd does so through society conditioning and intellectual laziness. Once you understand the logic of not doing so, you can change your behaviour. Similarly, you know that you are an emotional being due to your race. However, again you can learn to control your emotions and minimise their impact by using a disciplined trading plan.

## **Tools To Trade Turning Points**

*“Buy when everyone else is selling and hold until everyone else is buying. This is more than a catchy slogan . It is the very essence of successful investment”*

John Paul Getty - How to be Rich

You should see from the above that if we can spot an emotional crowd and position ourselves in the opposite direction we can make great profits. Its not of course enough just to understand this, we need specific tools that can help us identify and act on these moves. There are number of tools available and we have outlined them in our “Shooting Star Trading Method.”

This method will help you not only identify an emotional crowd but will also help you act upon these situations for big profits.

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