The only reason that investors lose money in stock markets

The notion that human behaviour drives stock markets is not new.

It is human behaviour that drives a stock price up when the stock market investors believe that a listed company will be very successful, and this will translate to an increase in the share price.

The reverse is also true, when the sentiment with investors is that a listed company will not be successful then those investors that hold that share will sell that share and thereby increasing the supply of the share price in the market and then the share price will decrease.

In those times when the general investor behaviour is driving the overall market unrealistically upwards or downwards then often the market commentators will state that the ‘fundamentals” are no longer driving the market performance, but the market is now said to be “sentiment” driven. “Sentiment” is simply another word for human behaviour.

Ultimately though, there is only 1 real reason that investors lose money on shares!

When the listed company's management cannot justify the listed share price.

When a share price is pushed too low it does not matter what management does to improve the performance of the share price, it is the sentiment of the investors that will keep the share price low, rightly or wrongly.

Similarly, when investors believe that a company will continue to perform unrealistically no matter what the management of the company does it will never be able to justify its share price. In many cases when this happens investors keep buying this share driving the share price even higher out of reach of the management's ability to justify the share price.

In the moment when the share price of a listed company no longer represents the performance of the underlying company, this is the moment that investors lose money on the share. This is true when markets are overheated and share prices are rising to rapidly for the listed company to continue delivering on and when markets are depressed, and sentiment is keeping share prices low no matter how well the listed company is able to perform.

Let's consider the following example:

Company A is a listed bread baking company.

Current Share Price	R1 000	
No of shares in issue	50	
Market Capitalisation	R50 000	
Bread per loaf price ex factory	R50	
Therefore, the number of bread loaves the company must sell to justify its share price	1 000	(50 000/ =1 000)

This illustrates that:

- If the **Company A** sells
    - 500 loaves then company cannot justify its share price
    - If only 500 loaves are sold, then management cannot justify the share price.
- But if the **Company A** sells
    - 1500 loaves then management is doing well and can justify the share price.

Fundamental investment theory tells us when **Company A** sells 1500 loaves then the share price should be high because management can justify its share price and when Company A only sells 500 bread loaves the share price should be low because management cannot justify its share price.

If only stock market investing was this simple!

We have to remember that current share price is reflection of 2 factors, past performance of the listed company (i.e. the level to which the management of the company was able to justify the share price at that time) and the forecasted future performance of the company.

The forecasted future performance of the company is the problematic measurement because this is a subjective measure of management's ability and skill to justify the share price. Forecasting is a probability game. It is trying to predict what the company will do in the future is what known in mathematics as an unknown variable.

Many fund managers and stock market investors try to solve for the unknown variable (to be able to forecast the future performance of the company) by conducting "due diligence". This means that they employ many analysts to look over the listed company's financial statements and visiting the company's business premises and then interviewing the management. Once the due diligence is completed, the analysts will compile a report which will try and model what the possible performance of the listed company will be.

Thereby increasing the human behaviour that drives markets.

But what if there is a way to invest in stock markets where one removes the forecasting of the future (Which is the unknown variable) by focussing on the known outcomes and then generating a probability of future performance?

This would in fact be similar to the way an actuary calculates the probability of a person claiming on their life insurance policy.

Think about it……An actuary asks the life assurance applicant questions about their current circumstances not what the applicant hopes his circumstances will be in the future.

Every time I have applied for a life insurance policy the application form asked me if I smoke (Not will I start smoking or will I stop smoking but do I currently smoke) and what my current weight is and if it has changed in the past 6 months by more than 5kg. These are known and constant facts not an unknown variable that predicts what might happen tomorrow.

If the life assurance applicant is reasonably young, does not smoke, has healthy lifestyle habits and does not have any pre-existing conditions then the probability of a claim on a life assurance policy is low and thus the life insurance premiums will be low because it reduces the probability of the insurance company receiving a claim on the policy.

Conversely, if the applicant smokes, is overweight, has a pre-existing medical condition then the probability of a claim being submitted to the life insurance company is higher and thus the premium is higher than our previously mentioned applicant.

New Age Alpha, an asset management company in New York have developed a method of assessing stock market listed company performance that uses actuarial principles to generate a probability of performance.

As a simplified example, let’s go back to **Company A** and the bread baking operation:

If **Company A** were to consistently sell 1500 loaves at R50 per loaf, then this would reflect in their financial statements that they have to publish every 6 months (in South Africa). Let’s say this was consistent over that 90% of the last 25 reporting periods where **Company A** was able to meet 1500 bread loaves at R50 each. Then the probability is high that Company A will be able to justify its share price in the future.

However, if **Company A** could only consistently sell 500 bread loaves over the same period then probability of the company being able to justify the share price is low.

New Age Alpha in New York have named the ability of a company’s management to deliver the “human factor”. If a listed company’s “Human Factor” score is high, then the probability of the company being able to justify it’s share price is very low and should be avoided.

Conversely if a listed company’s score is low then the probability of the company’s management being able to justify the share price is high and should be considered to be included in an investment portfolio.

Now, because share prices change constantly so does the “Human Factor” score. So, a share with a low “Human Factor” score today could be one with a high “Human

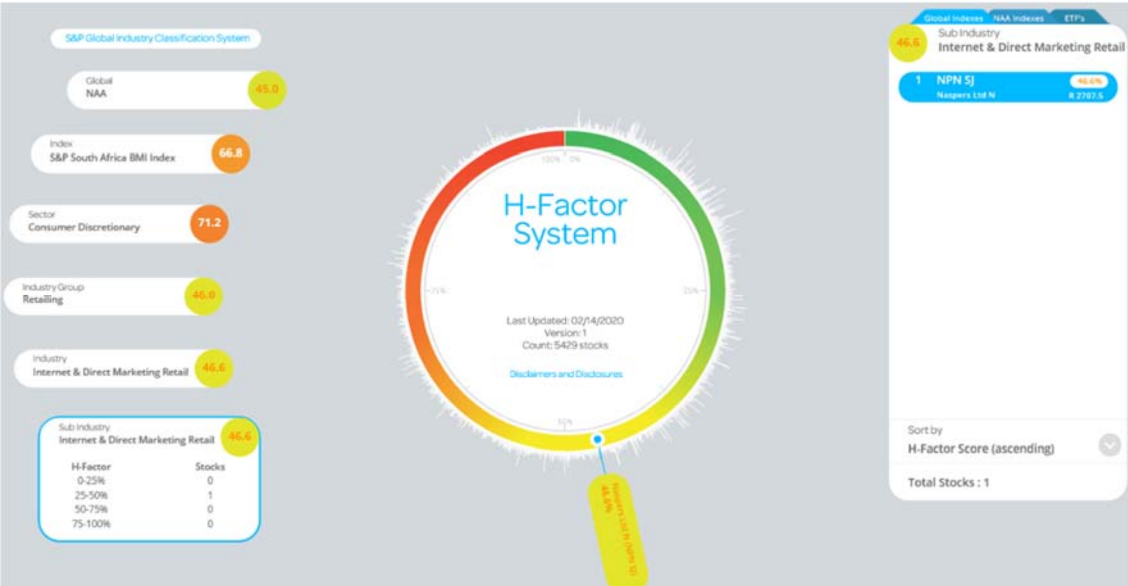
Factor” score tomorrow.

Want to know more?

Over the next few weeks we will be publishing articles which will delve deeper into the “Avoiding the Human Factor” investment strategy.

But we invite you to view our website www.glamasset.co.za and click on the "Avoid the Human Factor" banner and use the tool to see the “Human Factor” score of all your favourite listed companies.

Meantime, below is the Human Factor score for Naspers as at the 14th of February 2020, using the New Age Alpha “Human Factor” scoring tool. The tool reflects a yellow score of 46.6% which means that Naspers has a 46.6% chance of not being able to justify its share price.



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