

Investment Education Series



GTB Asset Management

VALUE INVESTING OR EMOTIONAL INVESTING?

What kind of investor are you? Are you the crowd following investor? Always on the lookout for opportunity to invest in red hot stocks; buying stocks when other investors are buying as well as running for cover when there's a stampede among investors trying to exit the market at the ominous sign of a bearish run? Or are your investment decisions modelled after the strategies of famous investors such as Warren Buffet, Kenneth Fisher, Peter Lynch and many others, who are value investors, basing their investment decisions on research, insight and analytical reflection?

The answer to the above question is the determining factor, responsible for the success or failure of an investor's investment. Research findings, has shown that most investors in the Nigerian capital market invest emotionally, basing their investment decisions primarily on what they read and hear from subjective sources. And owing to the overall objective of investing, which is to earn the best returns on funds invested, this study will highlight the features, challenges and benefits of value and emotional investment to enable investors choose a better guide for their investment decisions.

EMOTIONAL INVESTING

Emotional investment involves investment decision made under the control of human emotions of either, euphoria, fear, greed, group thinking and the likes. Emotional investors make decisions under conditions where emotion overpowers their ability to apply rational thinking in acting or reacting to events in the capital market.

Whether as an individual or institutional investor, the typical emotional investor depends on information from several sources, such as financial news media, word of mouth, friends and colleagues to guide their investment decisions which are often times short term in outlook.

Features of emotional investing include:

BAD TIMING

Because emotional investors depend on breaking news or gloomy projections on the capital market, they often end up on the wrong side of the market trend. For example there is usually a lag between when an event occurs and when it is reported and this typically causes investors to lose money. The uncertainty created by media opinions induce fear or euphoria, thereby influencing emotionally driven investors to make their move after the trend has peaked or is at its lowest level.

CONTAGION EFFECT

Emotional investors experience what is known in the investment industry as “*emotional contagion*”. Because the emotional investor follows the crowd, group behaviour becomes his/her natural disposition, influencing major and even minor investment decisions with far reaching effect. The world over, and in the Nigerian capital market, contagion has led to classic market blunders associated with following the crowd - buying into the market when prices are high, and fleeing in panic when they drop. Emotional contagion is relatively automatic, and entails the suppression of conventional rationality and caution. It also ignores the contrarian behaviour, which has been proven to be the best way to really make more money (ask Warren Buffet).

GREATER DOWNWARD THAN UPWARD PRESSURE

Because negative events tend to generate stronger and quicker emotional and cognitive responses than positive responses; when market trend toward a bearish run, the contagion effect sets off panic worse than the pressure or inclination to buy when the markets are booming and overheated. In a bid to avoid losses on their investments, investors in sheer blind panic desperately dump stocks leading to more panic and inevitably to an implosion.

BENEFITS

Emotional investing encourages imitating those whose investment strategies seem to be very successful (envy and greed are not good reasons though for following the leader) and fosters precautionary measures to mitigate potentially disastrous event.

In the light of the above defects, investment experts the world over has proffered ***emotional neutrality*** as the key to overcoming the contagion effect in emotional investing. They posit that better investment decisions can only be made in cold rational reasoning. An investor must never buy because people are buying in droves or join others to watch the tide in anticipation of a major market catalyst to induce a wave. Generally, heated emotions, euphoria, excitement and similar sentiment are the enemy of prudent and profitable investing.

VALUE INVESTMENT

Value investment is the strategy of selecting stocks that trade for less than their intrinsic value (i.e. true value of the investment exceed its current market value). Value investors are objective investors focusing on the history and estimation of the future growth, cash flows, present assets/earning among others of the business. A value investor invests with a long term perspective and is principally concerned about the potentials of the business, not on its stock price or market situate. They are meticulous investors, often spending long hours in detailed analytical study of the business fundamentals.

The major feature of value investing includes:

BUYING BUSINESSES

Value investors buy businesses, not stocks. They ignore trends in stock prices and other market noise. They look at the fundamentals that the stock represents and devote their time to research and find businesses selling at a good price based on probable future performance. The management style of the business is also very important; for good management can add value beyond a company's hard asset.

IGNORING THE MARKET COMPLETELY

Value investing encourages investors to consistently ignore trends in the market and focus on when they enter or exit a market. Investors should hold unto stocks as long as it meets their investment strategy; they should be slow to sell as they are to buy. For erratic selling exposes your portfolio to capital gains costs which usually requires selling a loser to balance it out, both of which comes with a transaction cost.

BUYING MORE OF SAME STOCK

When investors find businesses with very good margin of safety (principle of buying securities when the market price is significantly below its intrinsic value), value investing posit they buy as much as they can (presently undervalued stocks abound in the Nigeria capital market). The objective of the value investor is not diversification, but concentration of investment interest in businesses they have spent time studying and understanding their fundamentals.

BENEFITS

The benefits of value investment are numerous and evident in the history of the capital markets all over the world. Warren Buffet remains the best testimonial of the benefit and potency of value investment. Value investing also conserves energy drained by pursuing multiple stock options and saves money paid out as transaction and capital gain costs from several selling transactions. The mixture of common sense and contrarian thinking are hallmarks of value investing which has made more investors richer and fulfilled all over the world.

The bottom line remains that all investors seek to earn maximum return on their investment, whether in the short term or long term, applying the 80:20 Pareto principle works best when investor apply value investing principle in making their investment decision.

As financial managers, we believe in serving our clients' and partners' insightful market information that would protect and prosper their investment objectives. And giving that the Nigerian capital market is awash with depressed stock prices with promising business fundamentals, we encourage you to adopt a value investment approach to acquire as much stocks as you can before the market become saturated by the much anticipated return of foreign investors.