# Stock market myths

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Investors at times underperform by following investing strategies that are based on perception rather than long-term research or reality. Even though there have been many studies showing what does work, several stock investing myths continue to exist. Understanding and avoiding these myths can make a substantial difference in wealth over your lifetime.

## Investing in stocks is just like gambling

This reasoning causes many people to shy away from the stock market. Why is investing in stocks inherently different from gambling? We need to review what it means to buy stocks. A share gives ownership in a company. It entitles the holder to a claim on assets as well as a fraction of the profits that the company generates. At times, investors think of shares as simply a trading vehicle and they forget that stock represents the ownership of a company.

In the stock market, investors are constantly trying to assess the profit that will be left over for shareholders. This is why stock prices fluctuate. The outlook for business conditions always changes and so are the future earnings of a company.

Assessing the value of a company isn't an easy practice. There are so many variables involved that the short-term price movements appear to be random (academics call this the Random Walk Theory); however, over the long term, a company is supposed to worth the present value of the profits it will make. In the short term, a company can survive without profits because of the expectations of future earnings, but no company can fool investors forever - eventually a company's stock price can be expected to show the true value of the firm.

Gambling, on the contrary, is a zero-sum game. It merely takes money from a loser and gives it to a winner. No value is ever created. By investing, we increase the overall wealth of an economy. As companies compete, they increase productivity and develop products that can make our lives better. Don't confuse investing and creating wealth with gambling's zero-sum game.

## Stock market is an exclusive club for brokers and rich people

There is a misconception that the stock market is limited to an exclusive segment as it is believed that only such people have access to relevant information. In reality there are no such restrictions. Usually rules and regulations imposed by an exchange and the regulator promote equal access to information. This is made easier with the development of electronic media.

## Fallen angels will always go up eventually

Whatever the reason for this myth's appeal, nothing is more destructive to amateur investors than thinking that a stock trading near a 52-week low is always a good buy. Think of this in terms of the old Wall Street quote, "Those who try to catch a falling knife only get hurt."

## Suppose you are looking at two stocks:

- X made an all-time high last year around Rs.50 but has since fallen to Rs.10 per share.
- Y is a smaller company but has recently gone from Rs.5 to Rs.10 per share.

Which stock would you buy? Believe it or not, all things being equal, a majority of investors might at times choose the stock that has fallen from Rs.50 because they believe that it might eventually make it back up to those levels again. Thinking this way might be risky in investing. Price is only one part of the investing equation (which is different from trading, which uses technical analysis). The goal is to buy good companies at a reasonable price. Buying companies solely because their market price has fallen is questionable. Make sure you don't confuse this practice with value investing, which is buying high-quality companies that are undervalued by the market.

## A little knowledge is better than none

Knowing something is generally better than nothing but it is crucial in the stock market that individual investors have a clear understanding of what they are doing with their money. Investors who really do their homework are the ones who succeed. Don't worry, if you don't have the time to fully understand what to do with your money, you can always obtain the assistance of an investment advisor to enhance your knowledge.

## In order to get better returns, you have to be willing to take more risk

One of the most pervasive stock market myths is that in order to maximize your returns you need to always take more risks. It is important to minimize your risk at all times.

While a few of these high-growth, high-risk stocks do wind up paying off for investors, taking more risk as a whole doesn't always equal a greater reward. Take Warren Buffett as a good example. His entire investment philosophy revolves around minimizing his risk and buying safe companies whose products practically sell themselves. You'd be hard-pressed to discredit the idea that you can't get rich by investing in so-called 'safe stocks' once you've learned about how Warren Buffett made his billions. In other words, you can buy safe blue-chip stocks that are growing by a few percent a year or you can invest in companies with cutting-edge technologies and products.

## History always repeats itself

To some degree, history does repeat itself – no bull market or bear market lasts forever. Just like a broken clock is right twice daily, forecasters will at some point be correct that the stock market hit a temporary top or bottom.

But, history is far from a certainty to repeat; otherwise we'd all be looking to the past in order to get rich in the present. For instance, what caused the last economic downturn is unlikely to be the cause of the next economic bubble bursting. Investors need to accept the fact that they will not be able to always accurately predict the stock market.

## Penny stocks can double in value easier than a large-cap stock

The idea here is that it's a lot easier for penny stock or small-cap stock to double in value than it is for a stock with a higher share price or market valuation.
In reality, everything comes down to investors' perception of a stock. If investors believe a stock is worth twice as much as it is now, then the stock in question is potentially going to double whether it's Rs.100 a share or Rs.1 a share.

In fact, penny stocks can be potentially dangerous for investors as institutional investors tend to shy away from investing in single-digit share price stocks.

## Dividend stocks are incapable of delivering a high rate of return

The thinking here is that companies which pay their shareholders a dividend are often in the mature portion of their growth cycle and as such should see their stock price advance at a much slower pace than companies that don't pay a dividend and are reinvesting back into their business. In reality, when it comes to stocks you cannot generalize such statements. As you know there will be so many other factors that would influence the rate of return.
Don't forget that dividends are a waving beacon to investors of the health of a business' long-term business model and cash flow.

## Popular products might make great investments

Finally, there's the idea that popular products will undoubtedly become great investments. There's some degree of truth to this. But, sometimes it takes more than a great product to lead to a great investment. A company needs to have a good management team and be able to make money in order for its stock price to advance.

The lesson is simple: great products would not simply lead to great investments unless it has a clearly defined path to profitability along with a myriad of other factors.

## Large-cap stocks are the only option

There are many stocks other than large-cap stocks that can make good investments. As an individual, you are not tied to an investment objective that restricts you to only buying large-cap stocks, so take advantage of your freedom.

Smaller companies tend to be overlooked more and therefore their stocks have a greater chance of being underpriced. At times smaller-cap stocks are subjected to more price volatility and will have lower levels of trading volume, so there is a trade-off for the higher level of returns.

## The bottom line

It is said, "What's obvious is obviously wrong." This means that knowing a little bit will only have you following the crowd aimlessly. Think of a partially informed investor as a partially informed surgeon; the mistakes could reduce your profitability.

***Source: Daily Mirror***