Why do stock prices go up and down? And why do so many investors buy stocks when prices are up and sell when prices are down? Answers to these questions matter to all investors who have seen the stock market go up before the financial crisis, plunge in the depths of the financial crisis, and recover since then. Investors who persisted in their long-term investment plans into the whole market and weathered the short-term plunge are reaping their long-term rewards, leaving behind investors who sold their stocks during the plunge.

Stock prices are steered up and down by two drivers, a fundamentals driver and a sentiment driver. The fundamentals driver steers prices in directions pointed by fundamentals. The fundamentals of a coming financial crisis point down and the fundamentals driver steers prices down. The fundamentals of increasing corporate profitability point up and the fundamentals driver steers prices up.

The sentiment driver steers prices in directions pointed by cognitive errors and misleading emotions. The sentiment driver overpowers the fundamentals driver when sentiment is strongly positive, forming bubbles by steering prices up above prices justified by fundamentals. And the sentiment driver overpowers the fundamentals driver when sentiment is strongly negative, forming negative bubbles by steering prices down below prices justified by fundamentals.

Cognitive errors are various ways our minds convince us of things that really aren't true. One of these errors is called erroneous extrapolation of returns, which means making flawed predictions about returns. Examples of this would be forecasting high stock returns in early 2000, following the high returns of 1999, when the technology revolution was vivid. And erroneous extrapolation led many to forecast low stock returns in early 2009, following the low returns of 2008, when the financial crisis was vivid. Exuberance and fear are emotions that can magnify cognitive errors and strengthen the hands of the sentiment driver as he struggles with the fundamentals driver. Exuberance made it easy for the sentiment driver to overpower the fundamentals driver in early 2000, steering stock prices too high, creating a bubble. Fear made it easy for the sentiment driver to overpower the fundamentals drivers in early 2009, steering prices too low, creating a negative bubble.

A question comes naturally to mind — why not bet against bubbles? The answer is in another cognitive error — hindsight error. Bubbles are seen clearly in hindsight, but they are not seen as clearly in foresight. Nuriel Roubini is renowned for seeing the coming financial crisis in foresight but foresight failed him in March 2009 as he strained to see the stock market that followed. Roubini was interviewed by Jeff Kearns of Bloomberg on March 9, 2009, the low point in the stock market when the S&P 500 Index stood at 677. "My main scenario," said Roubini, "is that it's highly likely it goes to 600 or below." None of that happened. Instead, the S&P 500 Index started a recovery we all see clearly in hindsight but did not see as clearly in foresight.
We've become accustomed to hearing over the last 12 months that stock markets have hit a new all-time high. Prior to 2013 we'd have to go all the way back to 2007 to find the previous new high on the S&P 500, but on average the market actually hits a new high almost once a month. Why is it that every long term stock market chart seems to go up and to the right?

Think about what investing is. Investing is the process of taking your own capital and sharing it with companies looking to grow, and who — for the price of your capital — will share their future profits with you. Capitalism means a company can take $1 of inputs and create output that is worth more. Invest- ing is the process of being able to participate in that venture. Imagine Starbucks working with numerous different vendors to source the beans for their coffee, the paper for their cups, the land for their stores, and yet are still able to make a profit on a $2 cup of coffee? The stock market is a collection of companies in all different industries trying to do the same thing — create outputs that are worth more than their inputs.

Why Does the Stock Market Go Down?

Many stock valuation formulas can be boiled down to the idea that a company is worth what it has on hand today — cash, inventory, real estate, plus its future cash flows. However, because those future cash flows are unknown, they must be discounted back to present value by a risk factor. The more shaky investors deem a company's future prospects, the lower the price they are willing to pay for it. The stock market is up over time but history also tells us it will oscillate from year to year and may experience multiple down years in a row. The key is to understand this instability in the markets to what he called “animal spirits” or our spontaneous urge to action rather than inaction. If we hear bad news we tend to react to that news, and often we overreact.

The stock market will decline from time to time but these declines have historically been only temporary. As we see in the chart, the long-term trend of the market is up over time but history also tells us it will oscillate from year to year and may experience multiple down years in a row. The key is to understand this and control our emotions (“animal spirits”) so that we don’t turn temporary stock market declines into potentially permanent portfolio losses.

Drawdown is the peak to trough decline during a specific record period of an investment or fund. It is usually quoted as the percentage between the peak to the trough. Hypothetical value of $1 invested on January 1, 1926 and kept invested through December 31, 2013. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment indexes or unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.
Why do investors buy high and sell low? Why do stock prices go up and down? And why do so many investors buy stocks when prices are up and sell when prices are down? Answers to these questions matter to all investors who have seen the stock market go up before the financial crisis, plunge in the depths of the financial crisis, and recover since then. Investors who persisted in their long-term investment plans into the whole market and weathered the short-term plunge are reaping their long-term rewards, leaving behind investors who sold their stocks during the plunge.

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A question comes naturally to mind — why not bet against the stocks that really aren’t going anywhere? To a casual observer, the workings of global stock markets can sometimes seem confusing, even mysterious. A beaten-down stock suddenly soars, even as the stock of a well-run, profitable company stagnates. Strong economic data can elate investors—...or alarm them. Even a country wracked by coups and civil unrest may enjoy a booming market. From day-to-day, week-to-week it all just seems like a noisy mess.

As William Feather once observed, “One of the funniest things about the stock market is that every time one man buys, another sells, and both think they are astute.”

No wonder volatility is an almost daily constant. As the chart below shows, investors in the S&P 500 in recent years have had a 46% chance of losing money on any one day. (However, as we expand our time horizon, the probability of loss decreases substantially.)

The fact is simply this: volatility and uncertainty are the price of admission of investing. Where there is no risk, there is little reward, which is why you cannot make much money on a ‘sure’ thing. A stock market that always rewarded investors and a stock market that never made anyone money would both quickly collapse. Only a market that has both up and down periods offers the potential for long-term returns.

While we can’t predict when these ups and downs will occur, we do know—...in general—that markets rise and fall for rational reasons. In this special issue, we explain why.

Probability of Losing Money with the S&P 500 — 1994-2013

Don’t gamble. Take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don’t go up, don’t buy it.

— WILL ROGERS

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