Investing in the Secondary Market: Common Mistakes

In a previous article we highlighted some common mistakes investors make when investing in the primary market (when applying for shares from an Initial Public Offering). This article will mainly focus on mistakes done by investors when investing in the secondary market (when buying and selling shares through the stock market).

Highlighted below are some common mistakes made when investing in the secondary market;

1) Trading in shares without a proper understanding or knowledge of the stock market

It is imperative to gain a sound understanding about the stock market before investing. But however, some investors start trading in shares with minimal knowledge or no understanding about stock trading. This is a very short sighted approach to investing. Unlike other avenues of investment, stock market investments can bring forth very high returns as well as losses due to the element of risk attached to it.

The stock market is prone to price fluctuations. Knowledgeable investors tend to buy shares when the stock market is down whilst some who are not so sound on the fundamentals of investing sell their shares. There are certain others who also tend to buy shares when the stock market is soaring. However, a smart investor waits for the stock prices to decrease to buy shares and sells high when the prices increase.

It is important to note that an average investor or even an analyst who does research on the subject will find it extremely difficult to predict the highs and lows of stock price fluctuations or how the stock market will perform 100% accurately. Therefore, when investing in a stock one should establish profit goals. In other words, establish a set amount of profit to make on a stock. For example, to purchase stock in Company X for the price of Rs. 10 per share at its current trading value establishes your starting point. Say you set your profit goals for this particular stock at 30% or a Rs. 3.00 increase in stock price; A healthy return on any stock investment. So when the stock reaches Rs. 13 you have reached your profit goal for this stock and you should sell. Walking away with 30% gain on your investment is good, and far better than your money would have earned in any other place.

To harvest maximum returns from the stock market it is essential that you be well-versed about the subject. Do your own research: ask other investors, try to gather information from the regulator, various books, reports and articles written on the capital market, explore internet sources, speak to persons in the industry about the company, the business/sector, and any fees you may incur from purchasing stocks, participate in investor education and awareness programmes and seminars conducted by the regulator Securities and Exchange Commission of Sri Lanka, stock exchange and stock broking companies. Make an effort to enhance your knowledge and understanding about investing in the stock market to curb your losses and increase profits.

2) Investing in the stock market with short term objectives

Stock market is a long term investment avenue. Investing in the stock market to gain profits in the short term can lead to various issues. But this does not mean that you cannot gain substantial returns from short term investments in the stock market. You can generate returns on your investment in the short term as well. However, you should not come in to the stock market with the sole intension of earning money in the short term as incase if the stock market plummets the repercussions will have to be borne by the investor himself.

Listed below are a few examples to justify that putting money in the stock market is a long term investment.

- During the period 1985 – 2011 investors have received a 28% return on their investment (Growth of the All Share Price Index and corresponding Dividends) annually through the stock market.
- During the 10 year period 2002 – 2011, return on investment has been on average 37% annually.
- During the period 1985 – 2011, investments made in treasury bills brought forth returns of only 14% per annum. In comparison the stock market has given double the returns on investment during that period.

This clearly depicts that the stock market is a profitable long term investment option.

3) Not Prepared to Take Losses

Generally, the local investors are very much reluctant to cut losses and it can be considered as one the greatest mistakes made by the investors. Apart from the emerging investment markets, this phenomenon exists even in the developed markets like that of US where the investors appear to be savvier.

As a matter of fact, the intensity of pain goes higher when someone is confronted with a loss. As the investors are reluctant to face the pain, they keep their loss-making stocks year after year. They don't feel the pain until they sell these loss-making stocks. It does sound silly but that is the way people deal with pain and pleasure. Sooner or later, you will kind of "forget" about the losing stocks and also the pain associated with it.

4) Trying to make the stock market a casino

Buying shares from the stock market is an investment. It is not gambling. Share prices fluctuate due to the supply and demand of investors. Several fundamentals affect this. But gambling is purely based on one's luck.

Some investors try to make the stock market a casino. Rather than making sound investment decisions they try to gamble their way through. Certain new investors who enter the stock market tend to invest in shares based on their luck rather than considering the fundamentals. In some instances they purchase shares that go up in price without any valid reason or if not on speculation. They refuse to accept that investing in the stock market is a long term investment based on fundamentals. They try to make a casino out of the stock market by purchasing shares caught to the "trend".

In gambling the dice rolls a 6 depending on one's luck. Therefore the one who is lucky will win. But in the stock market if the share prices keep increasing all the investors who invest in shares will benefit.

Investors need to study the financial statements of companies that they intend to buy shares from. It is important to know the company, its history, about the Board of Directors, profit statements, business environment, future goals and the macroeconomic landscape of the country. Buying and selling shares should be based on these factors as every investor wants to purchase stocks in a healthy company that will see future returns and not one that is on a fatal path downward. Purchasing shares of a company is to invest in its future progress. This would also make your savings a profitable investment whilst boosting the economy of the country. These benefits cannot be attained through gambling.

Investing in shares of a particular company means that you are contributing to the profits of that company. It also denotes that you have acquired a percentage of that company's ownership. The shareholder will receive profits when the company makes profits (price per share will also escalate) and the shareholder will incur losses when the company makes losses (price per share will also decrease). Therefore it is justified that price fluctuations of shares have no correlation to luck. A company's profitability will depend on the success of the business, its environment and decisions made by its Board of Directors.

It is important to note that a company will not make profits overnight; instead it will require a substantial period of time to grow and prosper. Therefore, investing in shares of a company is a long term investment avenue. The share price depicts a company's profitability implicating that the company creates value for its shareholders. Value creation does not take place in gambling. Investing in the stock market means buying shares of right companies based on strong fundamentals at the right time. Thus, unlike in gambling, smart investing requires time, knowledge and experience.

Some investors enter the stock market with nothing but a casino mentality disregarding all the factors mentioned above. They tend to buy shares in the morning and sell them off within a few minutes or hours with the intension of making instant profits. It is imprudent for new investors to enter the market with such a mentality and same applies for existing investors who trade with such sentiments. However, this does not mean that it is wrong to earn instant profits or to engage in day trading (buy and sell share on the same day). This happens in stock markets around the world. But what investors should understand and bear in mind is that it involves a high element of risk. If a person who invests money in the stock market to make profits via day trading is unable to do so; he/she will face many obstacles. If an investor enters the market without anticipating short term returns and however is benefited on the short term it is an additional return on his/her investment.

5) To Hurry to Take Profit

It has been observed that in a hurry of taking profit, most of the investors sell out the money-making stocks instead of the loss-making stocks. In this process they run out of quality stocks and become a typical accumulator of “trash”.

When the investors take early profit they are exposed to a number of mistakes. Hence, the right approaches are as follows:

- Taking early profit should never be applicable for investment-grade stock but may applicable stocks meant for trading.
- The investors need to preserve quality stocks instead of the poor quality stocks.
- It is important for investors to adopt a cut-loss strategy as the profit-taking strategy alone doesn’t make any sense.

6) Becoming Impatient

Impatience of the investors can be treated as one of the most common mistakes. It is more common among the retail investors who generally want to make quick gains. They generally don't have any interest in the stocks which yields 10% per year. They rather go for those stocks which make 10% within a week or become double within a year.

Moreover, the retail investors mostly rely on tips and keep monitoring the stock very closely immediately after purchasing it. They praise the person for his tips when the prices go up. On the other hand, if the prices don't move up within a few weeks, they become very impatient. But according to the investment experts, investment grade stocks need to be kept for a long time for getting the best outcome

Before you make any investment, you need to get prepared to accept losses as a business component. At the same time, you need to be rational and consider stocks from an impartial point of view. In case of any mistake, you should not hesitate to take losses and cut the stock as much as possible

"The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell".

John Templeton