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—HEATHER LARSON-BLAKESTAD, Executive Editor, *Stocks, Futures, and Options Magazine*

TRADING REALITIES

THE TRUTH, THE LIES, AND THE HYPE IN-BETWEEN

JEFF AUGEN

AUTHOR OF *THE VOLATILITY EDGE IN OPTIONS TRADING*

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The Truth, the Lies, and the Hype In-Between

Jeff Augen

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To Takahashi Sensei who represents the very best of everything—focus, discipline, hard work, and unending dedication to achieving perfection.

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Preface

Most investors who buy a stock believe that they are investing in a company. That view, while technically correct, is also misleading. A stock investment is really nothing more than a bet on the direction that money will take as it flows through the financial markets. A stock can rise only if market forces align to aggressively drive up the bid price causing new money to flow into the stock.

Many different factors are involved including economic news, announcements from other companies in the same industry, political events, the actions of large institutional investors, analysts' forecasts, and a variety of global economic forces such as changes to currency exchange rates and interest rates. The long-term performance of a stock represents nothing more than the compounded effect of these forces over time.

It is also important to recognize that the financial markets are a zero sum game with competition at all levels. The stock market competes for money against the bond and currency markets; industries compete for money with each other; and money flows between stocks within a particular industry. An individual stock can fall because money is flowing into the bond market. It can also fall because money is flowing into another stock in the same industry. Conversely, the stock of a poorly performing company can rise if market forces are properly aligned. All factors considered, the price of

a stock is often only loosely connected to the performance of the underlying company.

There was a time, not long ago, when individual investors were the dominant force in the market. Buying a stock was equivalent to betting on the behavior of the other market participants. Those days have passed. Today's markets react to economic news in a fraction of a second, with computer algorithms driving most of the behavior. Heavily traded stocks in the S&P 100 or Dow rise and fall for reasons that are nearly impossible to understand at the individual stock level.

Investors who recognize these complex dynamics can gain an advantage because they have a balanced, realistic view of the problem. They spend most of their time identifying the underlying forces driving the markets, and they always try to invest with those forces instead of against them. In this regard, the most important attribute an investor can have is humbleness because successful investing is a never-ending struggle. The goal of this book is to make that struggle easier.

First Principles

This book is designed to help investors understand the economic and political forces that drive financial markets and to invest *alongside* those forces instead of *against* them. It also provides a blunt assessment of the limitations that most private investors face. Understanding these limitations and being able to manage risk are as important as choosing the right investments.

The following basic principles are central to the theme of this book:

- Financial markets, and stock markets in particular, always move in the direction that will do the most damage to the most investors. There are valid mathematical reasons underlying this assertion. In the most basic terms, when a large number of investors are on one side of the market and the market moves against them, the short-term losses create a wave of activity that becomes self-reinforcing. It is for this very reason that high-volume days with the most aggressive buying tend to occur just before sharp corrections.

- Financial markets are interrelated. Understanding the effects of one market on another is critical to successful investing. Nobody should ever invest in a market that doesn't make sense to them. In this regard, it is critical to be able to rationalize moves of the market with changes in the economy and financial news.
- Individual stocks tend to be swept along by the market. Even the best companies suffer declines during a market correction, and the worst companies can rally in a strong bull market. The gap between market and individual stock performance is not always obvious.
- Many investors blame the market when their stocks decline and credit themselves with wise investing when the same stocks rise. They never take the opposite view—that is, they never believe that they're lucky when they make money and that their losses are due to bad investment decisions. Taking a more pessimistic view will make you a better investor. It will drive you to work harder and be more diligent. Blame yourself, not the market, for losses.
- Experienced investors tend to overrate their knowledge about the companies they invest in. Gaining insights not already known to the market is a very difficult undertaking. Quarterly reports and analyst reviews cannot fill the gap. If you can't describe a company in terms of its revenue streams, sales pipelines, distribution channels, product roadmaps, and business models, then you don't understand the

company well enough to become a shareholder. Recognize that buying shares of stock is equivalent to purchasing a minority stake in a company. Don't invest in a company that you wouldn't feel comfortable owning, and if you can't gain that level of comfort then don't invest.

- The ability to interpret and understand government reports and news releases is a critical skill. These reports contain a wealth of information buried at a level of detail that most investors try to avoid. It is a mistake to let the financial news media interpret this information for you. Complexity and detail are your friends because they allow you to gain an advantage over the market and lazy investors who are unwilling to do their own homework.
- Understanding and avoiding risk is a key component of basic investing. Understand the relative risks of different financial instruments and avoid overusing leverage. Don't be fooled into believing that interest-earning investments are automatically safe. The most dangerous three words in the investment world are "can't possibly happen."

These concepts will weigh heavily in our discussions. However, they are not intended as simple guidelines and, on their own, they cannot be used to choose profitable trades. They are intended as background themes that can be used to guide your thinking.

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