Sharks and Lemmings:
How the Stock Market REALLY Works

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One of the major mysteries of the stock market is how it works. The truth is that nobody knows the answer. All those talking heads on the TV and radio programs are just filling up air time. It does not matter if the market goes up or down, the gain or loss will be blamed on whatever happens to be in the news that day. There are many different forces moving through the market at any given time, forces dealing with economics, information, and individual behavior (or lack thereof). Even if everything cannot be known about the market, some specific things can be discerned. One of the most important things about the market from the small investor's viewpoint is the fact that small investors often get the short end of the deal and wind up giving their money to someone else. Bummer!

The Economics of It All

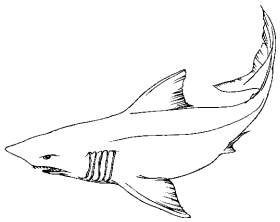
Though the term economics is a bit too long to be a four letter word, it is close enough. Anyone who claims to understand this dismal science is fooling himself even more than the studio audience. The real basis of economics was detailed in George Orwell's Animal Farm which made the astute observation that equality is variable. Nowhere is the application of such barnyard economics more obvious than in the stock market. Though laws have been passed to keep the large predators at bay, there is still enough size difference between the inhabitants of the barnyard to illustrate the fundamental Orwellian principle that some animals are more equal than others.

The Players

The stock market really belongs to the big players, the pension funds, mutual funds, and other organizations whose business is to play with big money. This money really belongs to depositors or shareholders, so it can be said that these investments really belong to small investors, too. But when the big players move through the market, the small players will get run over. The old saying goes "When the elephants dance, get out of the way." This assumes, of course, that you know what a dancing elephant looks like and have a certain amount of common sense.

Insult is added to injury when the behavior of the small investors is examined. One area of investment theory is called Contrarian Theory. The idea here is that if a person cannot be right all the time, he find someone who is wrong all the time and do exactly the opposite. As might be expected, small investors are the basis of several Contrarian investment theories. It seems that small investors have a real talent for doing the wrong thing and being in the wrong place at the wrong time. That is why they get run over by the bulls or the bears or the elephants or whatever animal is running through the market at the time. There have been a number of studies that confirm this sad phenomenon.

If the market is split according to expertise and the ability to work in the market, then there are really only two types of players, professionals and amateurs. The professionals are the big money managers who do things with large piles of other people's money. The amateurs are the small investors who are trying to star in their own version of the American dream. The behavioral patterns of the professionals and amateurs can best be understood by examining certain animals and their behavior patterns.



Professional investors can be characterized as sharks. These folks play for keeps, and their professional stature and income depends on how well they play. The successful sharks are quick and merciless. It is not just that nice guys finish last; nice guys become lunch, as does anyone who happens to be slower than the shark. The sharks have quick access to information and react almost instantaneously to news, whether it is true or not. Sharks have a lot of money to play with, and with the luxury of deep pockets they can hold onto an investment that might seem temporarily weak. Sharks are trained to take advantage of every opening the market presents, and the market is the teacher. The market is the day job for the sharks.

Small investors, on the other hand, are best characterized as lemmings. Lemmings are weasel-like rodents that live in Scandinavia. Every seven years or so there is a population explosion of lemmings, and all the food in their home territory is eaten. So the lemmings have to search for a new dining area, and this is where things get interesting. When the lemmings go hunting for food, they move in a straight line,

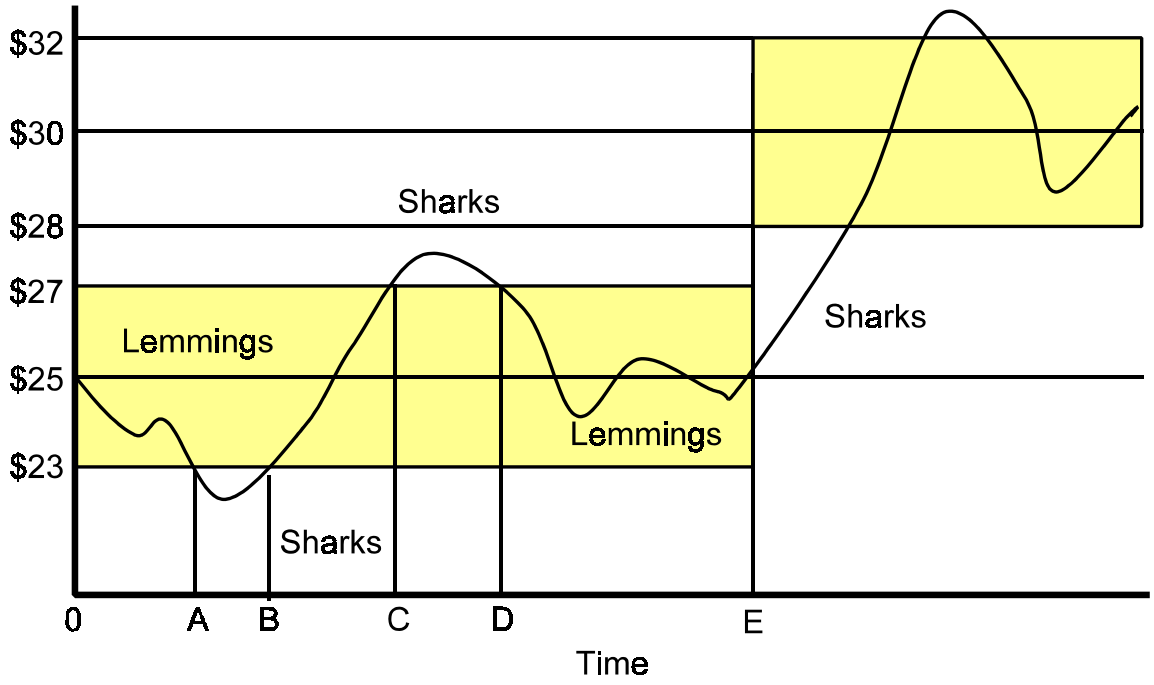
regardless of where that line leads. If the line of march leads across a highway, the lemmings go across the highway, heedless of traffic and casualties. The geography of Scandinavia also throws a curve at these little critters. If the line of march leads to one of the many fiords, the lead lemmings simply jump off the cliff and drown, and all the other lemmings follow. Though their motives are noble and their hearts may be pure, lemmings have a fatal behavioral flaw. They follow movement blindly.

Small investors behave like lemmings not from stupidity but from necessity. One of the most important characteristics of small investors is that they have very shallow pockets. That is the reason they are small; they do not have enough money to be big. Any small movement of a stock price might mean the difference between having a comfortable retirement in Florida or living in a basement apartment at the kids. Lack of lots of liquidity can force even the smartest small investor to jump off a financial cliff. And once a lemming has jumped off the cliff, the sharks are waiting.

This might not seem fair, but the market is not about fairness. The market is about being smarter than the other guy and taking his money. This is the motivation of the lemmings as well as the sharks. The only real differences between the two groups of players are size and skill, and that is enough to make a big difference.

Market Behavior

To see how the sharks and lemmings interact, assume that the stock in Little Joe's Chicken Plucking Company (LJCP) is currently priced at $25 per share, and that this is an absolutely fair price that reflects all the information in the market concerning everything. (This information came down from the mountain, so there is no point wasting time in arguing about its accuracy.) Since LJCP is a widely held stock, both large and small investors own some of it, and all players start with the knowledge that LJCP is really worth $25. All the players are in the game for the same reason, to make money. Both the lemmings and the sharks are playing with the same motives, and none of these motives involve mercy. The following diagram shows how the game is really played.



At time=0, the LJCP stock is fairly priced at $25. Neither the sharks nor the lemmings have any particular reason to buy or sell the stock, except for personal or maintenance reasons. Even though there is no new information concerning the prospects of LJCP and hence the value of the stock, the market price of the stock varies a bit due to the forces of demand/supply in the market. If there is more demand than supply, the price goes up; if there is more supply than demand, the price goes down. The diagram indicates that beginning at time=0, a few more sell orders hit the market than buy orders, so the price of the stock falls a little simply due to market dynamics.

All the players, sharks and lemmings alike, know that stock prices move a bit, but the lemmings are more sensitive to price movement due to their shallow pockets. Lemmings, the small investors, establish for themselves price boundaries beyond which they will take action. If the price of the stock drops too far, the lemmings sell the stock so that they do not lose too much of their hard-earned money. If the price of the stock goes up, the lemmings grab the profits while they can. In the diagram, the average lemming is shown as having a ±$2 band around the fair price of the stock. This is an average value, and individual lemmings will have different boundaries.

The slight selling pressure that begins at time=0 drives the stock price downward. There might be no reason for this selling pressure other than a few investors chose to sell the stock at this time for their own personal reasons, but several sell orders hit the market at the same time causing the price to drop. As the price is falling, the lemmings with very narrow lower price boundaries will sell their stock, adding further downward pressure to the stock price. These are lemmings with very shallow pockets; even small price drops are feared since they mean the loss of some money. These lemmings are really amateurs and subject to all the mistakes that amateurs make. During this period, the sharks are not doing anything. These professionals have large portfolios to manage, and one stock going down a point or so is no big deal, especially if this price drop is considered to be a transient market condition.

At time=A, the lemmings are running for the cliff. The first lemmings that sold the stock are patting themselves on the back for being so smart, and as the stock price continues to drop because of all the sell orders, the remaining lemmings begin to panic and sell their LJCP stock to keep from losing more of their money. The actions of one group of lemmings causes another group of lemmings to join the march over the cliff. Time A is when the sharks start to take notice of the lemmings, and what they notice is lunch. The sharks know full well that the LJCP stock is worth $25, and if the lemmings are silly enough to sell it for a depressed price, the sharks reach into their deep pockets and buy up everything the lemmings are selling. Some sharks may move earlier than others, but there are plenty of lemmings.

The buying activity from the sharks stabilizes the stock price and maybe even causes it to rise a bit as the sharks start bidding against each other. At time=B, some of the lemmings start to notice that the stock price has stabilized. Lemmings tend to be personally attached to stock and watch the few firms in their portfolios very carefully. The stabilization of the stock price causes some of the lemmings to reevaluate the LJCP stock, and they find that it is really worth $25 (which is what they thought before). Since the stock is now selling at a discount, these lemmings start buying and create a demand that starts to force the stock price upward, and by time=B the price has risen into the range where the average lemming is comfortable.

The price momentum has now been reversed. Other lemmings start buying LJCP stock again. Those that sold the stock early and got a decent price see that they were right about the value of the firm all along and buy the stock to put back into their portfolios. Those lemmings that sold the stock at a lower price are kicking themselves for being so stupid as to sell a good stock before it went up, and they buy the stock to make back some of the money that they just lost. All the lemmings want to buy the stock, but they have to buy it from someone who already has it. The sharks own most of the LJCP shares now, and they know that it is worth $25, so they will not sell for below that price. The buying demand will force the stock price above $25, but the sharks might decide to hold the shares for a while to catch as much of the ride as possible.

The sharks start to divest their holdings at time=C, and there are plenty of lemmings out there willing to buy. After all, the stock has gone from below $23 to above $27, an increase of over 17%! Some lemmings who may have known nothing about the LJCP stock before this time see a stock that is rising rapidly (upward price momentum), so they decide to jump on the band wagon, too, and the buy orders keep coming in. New blood is entering the market, and the water, and none of it is blue. The sharks keep busy selling the lemmings the stock that the lemmings sold to them previously, but the sharks are taking the profits (you never go broke by taking profits). By time=D the selling pressure turns the price trend of the stock back down.

Once the sharks have sold all the LJCP stock they intend to sell, there could still be excess demand. The sharks know that the stock is only worth $25, so they can short-sell the stock to the lemmings, thus creating an artificially high supply of the stock[1]. This high supply will eventually force prices down as the lemmings run out of money, and the sharks will be able to buy the stock back at lower prices and make a profit when covering their short positions. Even if short selling is not done, when the sharks have sold out their positions, the lemmings are left with stock that is priced at greater than its fair value. At this

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[1] A short-sale is a deal where the shark borrows someone else's stock and sells it with the promise to put it back in the future, though the lender may not be aware that he has loaned his stock to the shark. It is even possible that the shark might sell the shares to the person he borrowed them from. It sounds fishy, but it is legal. This proves that you can make money if you sell high and buy low, just like you can when you do it the other way around. Though some lemmings play a bit with short-selling, it is primarily the domain of the sharks.

point, the smart lemmings realize it is time to sell the stock to the dumb lemmings. The dumb lemmings eventually realize that they paid too much for the stock and try to sell it to an even dumber lemming thus creating selling pressure in the market, and the price of the stock heads south.

If the lemmings really get scared, the downward trend of the prices could cause the whole panic to start all over again. Depending on the nature of the lemmings and the aggressiveness of the sharks, the price cycle could go on and on and on. The cycle would not be endless, though, since eventually the lemmings will have lost enough money that they are out of the game. Once all of the lemmings have jumped over the cliff and drowned, the sharks have to wait (but since there are a lot of stocks out there, the sharks do not have to wait very long to find another cliff and another group of lemmings). The price of the LJCP stock will stabilize right where it belongs at $25.

Time=E shows another way that the lemmings can get nipped by the sharks. Suppose that LJCP just got a government contract to provide featherbeds for all the Congressional staffers. This surely would be a lucrative contract and increase LJCP's profits for the next several years. Under these conditions, the fair price of LJCP stock could be $30 per share. When this news hits, the lemmings are all at work at their day jobs, and these jobs are not in the stock market. The sharks are positioned to hear the news first since they do work in the market, and they recognize its importance. The sharks immediately begin to buy the stock from any unsuspecting lemming who is willing to sell it, and the sharks initiate a price rise. Some of the smarter lemmings who are watching the market may not have heard the news and willingly sell their stock for $27 to some clown foolish enough to pay that much, since this means the lemming can lock in a profit. Either way, the lemmings give the sharks another luncheon. In this case the lemmings did not run off the cliff, the cliff dropped away beneath the lemmings. The result is the same. The sharks eat well at the expense of the lemmings.

The sharks are willing to bid up to $30 for the stock, which is a 20% increase over the current price. Once the sharks are done positioning themselves, the lemmings might start a price cycle all over again. Rest assured the sharks would be very willing to sell a stock worth $30 to any lemming who offers $33, even if it was the very same lemming who

originally sold the stock for $27. Eventually the stock price will settle around its fair value of $30, but not before there has been a lot of excitement, and a lot of lemming blood in the water. It really does not matter if the lemmings were reasonably intelligent, when the market starts to move, they can get caught up in the crowd of dumb lemmings.

The Outcome

This is really a bleak picture. The lemmings wind up as shark food regardless of what happens. And lemmings never seem to learn. Historically, just before the market crashes, all sorts of new investors are trying to find ways to become rich. What these investors often find out is that they end up poorer than they started. The greatest amount of enthusiasm in the world will not compensate for foolish behavior, especially in an arena like the stock market. Brave heart may win a fair lady, but excessive bravery can be very expensive.

But there is hope. The trick for the small investor is not to be a lemming. Lemming is an attitude brought about by lack of knowledge and/or fear. Lack of knowledge keeps lemmings from knowing what the true value of a stock is, and fear makes lemmings jump too quickly whenever the market is having a bad day. Small investors who are smart need not be lemmings; they can be baby sharks. The key is knowledge and courage.

There is even the possibility that knowledgeable small investors can outperform the sharks. Sharks have weaknesses, too, and an intelligent small investor can capitalize on these weaknesses. The most glaring weakness seen in sharks is their size. Sharks are large, fast-moving creatures who cannot be troubled with minnows. If something is small enough, it might escape the sharks' notice.

The managers of large funds have practical and legal limits on their actions. These folks play with millions of dollars in the time span it takes a normal person to put a quarter in a parking meter. The portfolios of the large players will have hundreds of stocks. But the portfolios cannot have every stock. Most money managers do not bother with smaller firms. There are legal restrictions about how much stock of a given company a money manager can own and still be regarded as an outside investor, and these sharks do not

want to get involved with managing small firms. Small companies are simply not of interest to sharks until they become large companies.

There have been a number of academic studies that indicate small firms do provide a higher than expected return on equity investments. These small firms do not have deep roots, yet, and are more subject to vagaries in the economy. Their profitability is more variable than large firms, hence these are riskier investments. But even if the excess risk is accounted for, small firms still yield higher than expected returns.

Small investors can do very well by focusing on smaller firms as part of their investment portfolios. Since the sharks are not interested in such companies, there is relatively low demand, so the price of the stock is relatively low (that is why there is a higher return). The small investor who takes the time to study the market and focus on smaller firms can outperform professional money managers. This is an experience that is repeated time and again by investment clubs. These nonprofessionals pool their talents and find investments that the big money managers ignore. The trick to not getting eaten by the sharks is not to be in the same water with the sharks.

Small investors need not be lemmings. Proper research and careful investing can work for any investor, large or small. Knowledge of the market and an understanding of fundamental characteristics of the firms and their securities are requisites to successful investing for anyone, large or small. And small investors must also remember not to fool around in those areas of the market dominated by deep pocketed professionals. When David goes up against Goliath in the stock market, Goliath wins; bet on it. A rule used in many areas of human endeavor is the KISS Principle, Keep It Simple, Stupid. The KISS principle is very important in investing, especially for small investors.

Summary

Small investors are subject to patterns of investing that typically serve to make the investor poorer. These suboptimal behaviors are the result of lack of knowledge and lack of money. Whenever the small investors start doing something stupid, the professional investors will be there to capitalize on that stupidity. The large professional investors have

the money and the know-how to make profits in any market, and the small investors are too often the source of that profit.

The small investor is not doomed, though. Intelligence is not the private domain of the professional player. Small investors can be just as smart and sometimes make better returns than professionals. The professional investors cannot be in all potential investments at one time and even have restrictions, either legal or practical, about the type of investments they can use. Small investors do indeed have the ability to prosper in the financial markets, as long as they do not act foolishly.