Some Misconceptions about Stocks and the Stock Market

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1. **Investing in stocks is the same as gambling**

One of the biggest dangers for investors is that they're speculating when they believe they're investing. Ben Graham made an important distinction between the two:

'An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.'

By this definition, most people who buy stocks are 'speculators', 'day traders' and 'players of the market'. In Edwin Lefèvre's classic book '*Reminiscences of a Stock Operator*':

> *The speculator is not an investor. His object is not to secure a steady return on his money at a good rate of interest, but to profit by either a rise or a fall in the price of whatever he may be speculating in.*

I have never tried to make quick 'securities' profits and try to trade in and out of businesses. This is because 1) I don't know how to and 2) It promotes the mindset of a trader, not an investor.

2. **The higher the share price, the more expensive the stock and vice versa**

The stock price tells you nothing about the value of the business. Management can make a company trade at whatever price it wishes through a series of stock splits and reverse stock splits. Instead, focus on the market cap and decide if you would buy the business in its entirety if you could.

Also, it is *not* easier for a $10 stock to go to $20 than a $500 stock to go to $1,000.

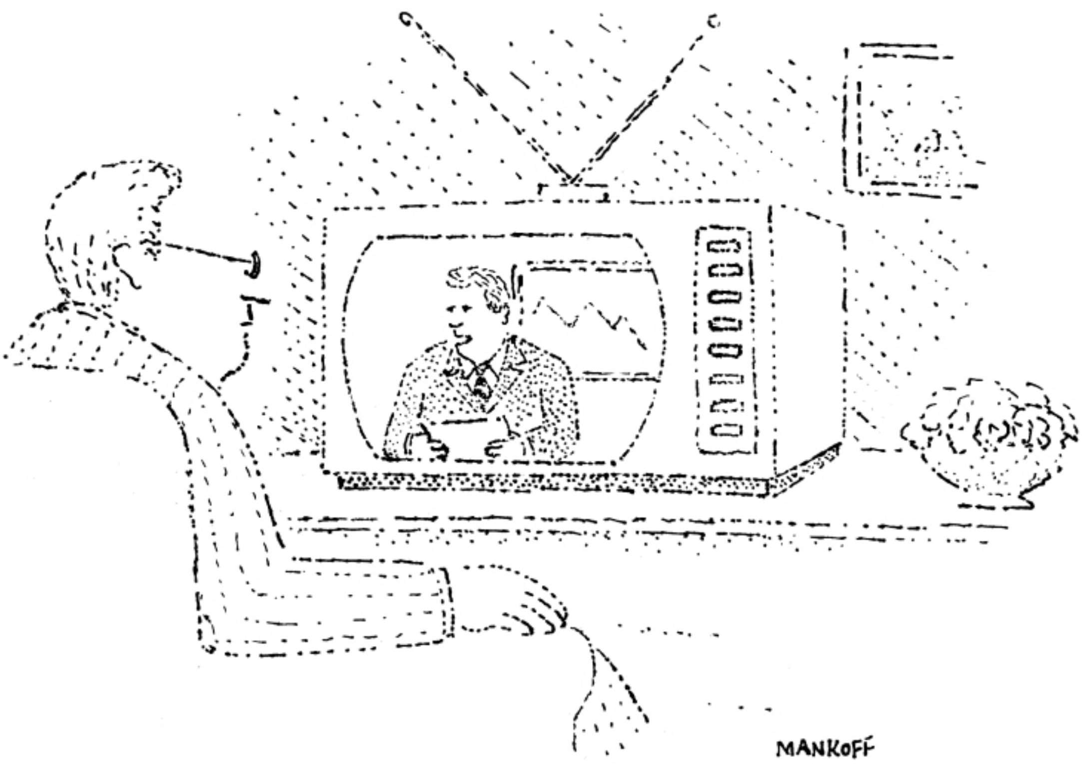
3. **A stock with a higher beta (volatility) is riskier**

Investors who can invest with a multi-decade horizon, quotational declines are unimportant. Risk is the permanent loss of capital when you invest in a business – not how much the stock price bounces around in the short-term.

Good investors understand that high return and low risk can be achieved simultaneously by buying assets below their intrinsic value (buying a dollar for 50 cents). Overpaying (buying a dollar for $1.20) implies both low return and high risk.

4. It is important to correctly make macroeconomic predictions

In investing, the micro factors trump the macro factors. Trying to figure out the future of a business is hard enough - don't try to figure out the future of the world. I personally invest on a strategy that makes the need to rely on economic assessments largely irrelevant.



"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."

5. The price/earnings ratio tells you how cheap or expensive a stock is

Just as a physician would not depend on a single reading to gauge human vitality, an investor should not depend on a single metric to gauge business vitality.

6. **Bonds are safe, stocks are risky**

No asset has the birth right of a high return. It's only attractive if it is priced right.

7. **You can make money based on stock tips**

The first rule of business is to do your due diligence. It is not enough to know the ticker symbol. You must know why you own the business, its competitive advantages and what it might reasonable be worth.

In February 2000, Jim Cramer wrote an article for TheStreet. This was right before the burst of the dot-com bubble. In the article Cramer said that internet related stocks 'are the only ones worth owning right now.' By year-end 2002, a $10,000 investment spread equally over Cramer's picks would have lost 94%.

8. **When you sell a stock, the company gets your money**

This one took me a long time to figure out.

Basically, there are two markets – the primary capital market and the secondary capital market. In the primary market, investors buy securities directly from the issuing companies and that money flows directly into their coffers. When a company publicly sells new stocks and bonds for the first time, it does so on the primary market. A good example is an IPO.

The secondary market is what we call the 'stock market'. This includes the major exchanges around the world. In the secondary market, people buy and sell securities they already own to other investors, with no money going to the companies that originally issued the securities.

Think of it this way. When you purchase a new car, the money goes straight to Toyota. That's the primary market. On the other hand, when you purchase a second-hand car, the money goes to the previous owner. That's the secondary market.