The Five Biggest Stock Market Myths

June 19, 2002 | By **Investopedia Staff**, (Investopedia.com)

When fiascos like the Enron bankruptcy, auditing scandals and analysts' conflict of interest occur, investor confidence can be at an all-time low. Many investors are wonder whether or not investing in stocks is worth all the hassle. At the same time, however, it's important to keep a realistic view of the stock market. Regardless of the real problems, common myths about the stock market often arise. Here we go over these myths in order to bust them.

1) Investing in stocks is just like gambling.
This reasoning causes many people to shy away from the stock market. To understand why investing in stocks is inherently different from gambling, we need to review what it means to buy stocks. A share of common stock is ownership in a company. It entitles the holder to a claim on assets as well as a fraction of the profits that the company generates. Too often, investors think of shares as simply a trading vehicle, and they forget that stock represents the ownership of a company.

In the stock market, investors are constantly trying to assess the profit that will be left over for shareholders. This is why stock prices fluctuate. The outlook for business conditions is always changing, and so are the future earnings of a company.

Assessing the value of a company isn't an easy practice. There are so many variables involved that the short-term price movements appear to be random (academics call this the Random Walk Theory); however, over the long term, a company is only worth the present value of the profits it will make. In the short term a company can survive without profits because of the expectations of future earnings, but no company can fool investors forever - eventually a company's stock price can be expected to show the true value of the firm.

Gambling, on the contrary, is a zero-sum game. It merely takes money from a loser and gives it to a winner. No value is ever created. By investing, we increase the overall wealth of an economy. As companies compete, they increase productivity and develop products that can make our lives better. Don't confuse investing and creating wealth with gambling's zero-sum game.

2) The stock market is an exclusive club in which only brokers and rich people make money.
Many market advisors claim to be able to call the markets' every turn. The fact is that almost every study done on this topic has proven that these claims are false. Most market prognosticators are notoriously inaccurate; furthermore, the advent of the internet has made the market much more open to the public than ever before. All the data and research tools previously available only to brokerages are now there for individuals to use.

Actually, individuals have an advantage over institutional investors because individuals can afford to be long-term oriented. The big money managers are under extreme pressure to get high returns every quarter. Their performance is often so scrutinized that they can't invest in opportunities that take some time to develop. Individuals have the ability to look beyond temporary downturns in favor of a long-term outlook.

3) Fallen angels will all go back up, eventually.
Whatever the reason for this myth's appeal, nothing is more destructive to amateur investors than thinking that a stock trading near a 52-week low is a good buy. Think of this in terms of the old Wall Street adage, "Those who try to catch a falling knife only get hurt."

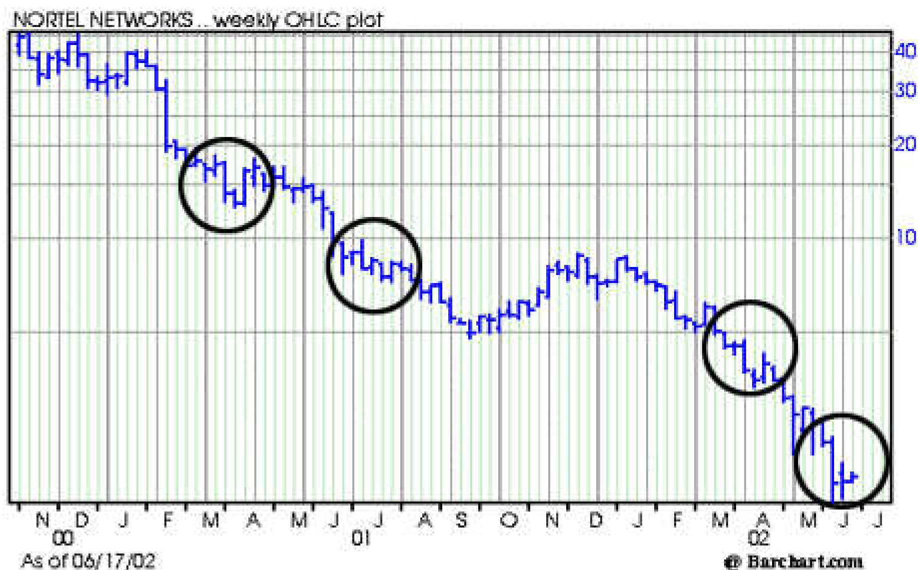
Suppose you are looking at two stocks:

- XYZ made an all time high last year around $50 but has since fallen to $10 per share.
- ABC is a smaller company but has recently gone from $5 to $10 per share.

Which stock would you buy? Believe it or not, all things being equal, a majority of investors choose the stock that has fallen from $50 because they believe that it will eventually make it back up to those levels again. Thinking this way is a cardinal sin in investing! Price is only one part of the investing equation (which is different from trading, whch uses technical analysis). The goal is to buy good companies at a reasonable price. Buying companies solely because their market price has fallen will get you nowhere. Make sure you don't confuse this practice with value investing, which is

buying high-quality companies that are undervalued by the market.

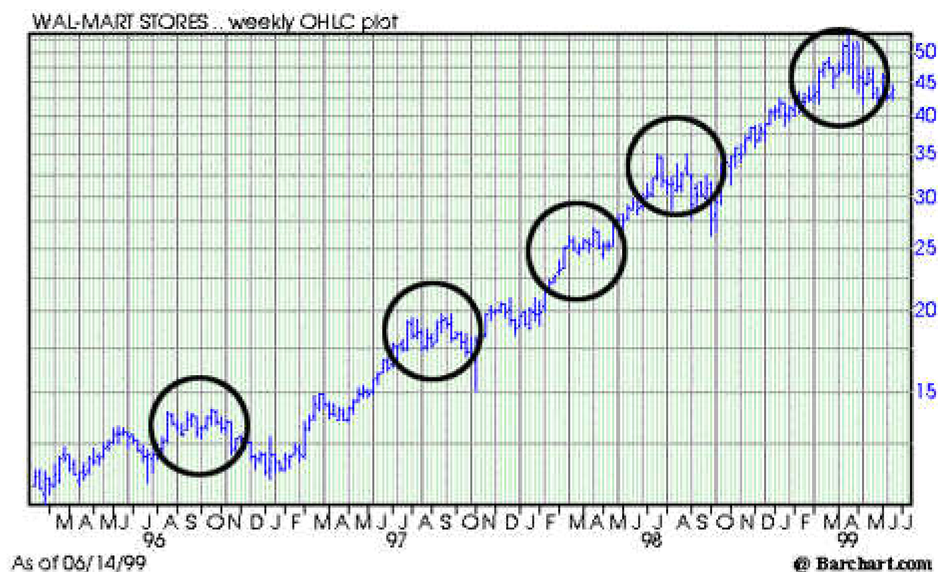
Below is a chart of Nortel's decline. Imagine how much money you would have lost had you bought Nortel just because it kept on hitting new lows!



This chart was supplied by Barchart.com

4) Stocks that go up must come down.
The laws of physics do not apply in the stock market. There is no gravitational force that pulls stocks back to even. Over ten years ago, Berkshire Hathaway's stock price went from $6,000 to $10,000 per share in a little more than a year. Had you thought that this stock was going to return to its lower initial position, you would have missed out on the subsequent rise to $70,000 per share over the following six years.

Below is a chart of Wal-Mart from 1997 to 2000. We've circled every time the stock chart hit resistance to reaching a new high. Those investors who were waiting for the stock to come back to earth would missed out on a return of 500% or more. What's behind the stock? It's the company! Wal-Mart is another example of an excellent company that has dominated its industry by being innovative and creating value for both shareholders and customers.



This chart was supplied by Barchart.com

We're not trying to tell you that stocks never undergo a correction. The point is that the stock price is a reflection of the company. If you find a great firm run by excellent managers, there is no reason the stock won't keep on going up.

5) Having just a little knowledge, because it is better than none, is enough to invest in the stock market.
Knowing something is generally better than nothing, but it is crucial in the stock market that individual investors have a clear understanding of what they are doing with their money. It's those investors who really do their homework that succeed.

Don't fret, if you don't have the time to fully understand what to do with your money, then having an advisor is not a bad thing. The cost of investing in something that you do not fully understand far outweighs the cost of using an investment advisor.

Conclusion
Forgive us for ending with more investing clichés, but there is another old adage that is very much worth repeating: "What's obvious is obviously wrong." This means that knowing a little bit will only have you following the crowd like a lemming. Like anything worth anything, successful investing takes hard work and effort. A partially informed investor is about as effective as a partially informed surgeon; he or she will only hurt themselves and those around them.

By **Investopedia Staff**, (Investopedia.com)

**** This article and more are available at Investopedia.com - Your Source for Investing Education ****