THE PSYCHOLOGY OF SPECULATION

THE HUMAN ELEMENT IN STOCK MARKET TRANSACTIONS

BY

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WITH
ILLUSTRATIONS BY HAYDON JONES

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THE PURPOSE OF THIS BOOK

There are many persons who, although knowing a great deal about the stock market, do not realize that the reason why they cannot "beat" it, is that they know too little about themselves. There are others who know their limitations well enough to let this monster problem alone. As it is important that one should learn to swim before plunging into deep water, so it is well to know some of the dangers of the stock market before delving into it.

It is not the purpose of this book to dissuade anyone from buying and selling securities, but merely to point out some of the stumbling blocks and handicapping influences that speculators, and even investors, are sure to encounter.

H. H. H.

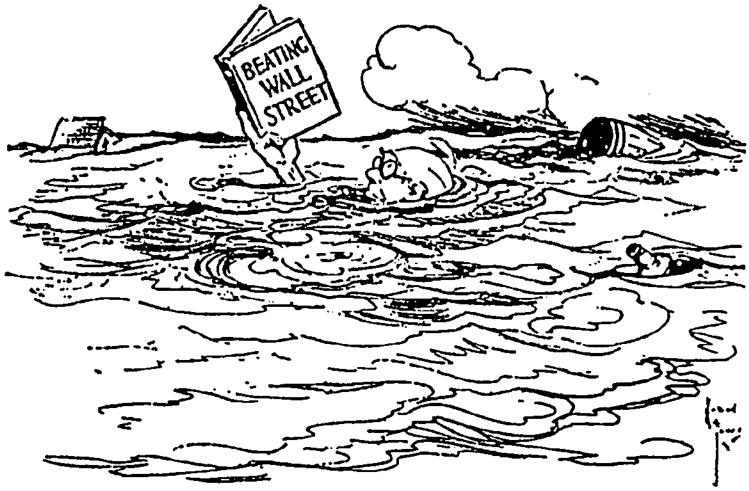
THE PSYCHOLOGY OF SPECULATION

THE HUMAN ELEMENT IN STOCK MARKET TRANSACTIONS

The stock market literature of the past thirty years would make a vast library in itself — one that would provide reading for a lifetime. Perhaps there is no other subject, apart from the eternal topic of love, in which more people are vitally concerned, either directly or indirectly. Since most of the country's wealth and commerce is controlled by corporations whose securities are listed on the various stock exchanges, the price fluctuations, which often reach the daily aggregate of hundreds of millions of dollars, either in loss or enhancement of value, are necessarily a matter of general concern. In 1925 the stock transactions on the New York Stock Exchange alone amounted to the stupendous and unprecedented total of well over 452,-

000,000 shares, while the sales of listed bonds totaled more than $3,398,000,000. These figures, of course, do not include the unknown billions of dollars worth of securities bought and sold on a dozen or more other exchanges and through private channels.

In addition to the large daily grist of "Market Opinions," many books and pamphlets are written which purport to be "Guides to Traders," or up-to-date recipes for "Beating Wall Street." They set forth an exhaustive array of statistics, instructions and warnings; they furnish elaborately charted plans indicating many of the pitfalls of speculation; they tell how to avoid these, how to buy, what to buy, when to buy and how to make money; but while the theories advanced are oftentimes sound and easily comprehended, very few people profit by them, because when once caught in the maelstrom of stock speculation the average man becomes more or less mesmerized, and at critical moments his conservatism, his resolutions and his theories all take flight. Under the discomposing influence of a rapid succession of changing values and alternating impulses he loses his perspective, is incapable of calm reasoning, and is likely to do precisely the opposite of what he had intended doing. Like a piece of driftwood in a swirling stream, his actions are controlled less by personal instigation



than by the currents about him. Therefore to write, however intelligently, or to read, however studiously, about how to make money in the stock market is largely wasted effort in imparting, also in acquiring, information that does not adequately inform. Not that the instructor's premises are faulty, or that the reader is deficient in understanding; but that the difficulties which necessarily attend the application of the scheme of operations subsisting in the mind of the author are so perplexing and disconcerting that the disciple becomes incapable of adhering to sound basic principles. And it must be perfectly obvious to anyone that even the teacher himself is not a master, but merely an expounder, of his own principles; for otherwise he would be a capitalist instead of a professional scribbler. Notwithstanding the many excellent books which have been written on the subject, the real secret of stock market success still remains (and probably always will remain) locked up in the bosoms of a few who are too busy to write, and too rich to feel the need of writing.

THE PERNICIOUS INFLUENCE OF THE STOCK TICKER

The individual who trades or invests in stocks will do well to keep away from the stock ticker; for the victim of "tickeritis" is no more capable of reasonable and self-composed action than one who is in the delirium of typhoid fever. The gyroscopic action of the prices recorded on the ticker-tape produces a sort of mental intoxication, which foreshortens the vision by involuntary sub-

missiveness to momentary influences. It also produces on some minds an effect somewhat similar to that which one feels after standing for a considerable time intently watching the water as it flows over Niagara Falls. Dozens of people, without any suicidal intentions, have been drawn into this current and dashed on the rocks below. And thousands daily are influenced by the stock ticker to commit the most fatuous blunders.

As a camera fails to record a true picture if placed in too close juxtaposition to the object, so in studying the ticker-tape one is restricted to a close-up view of conditions, resulting in a distorted gauge of values; for the figures recorded often mislead and confuse the attentive observer; in fact it frequently happens that the price fluctuations result from a wave of hysteria among a coterie of traders, and bear but little analogy to the true value of the stocks. To illustrate this point more explicitly, the stock of almost any conservatively capitalized and well managed concern paying six dollars annually in dividends has an investment value of from $85 to $100 a share; but in the ups and downs of the market the stock gets buffeted about on the exchange in obedience to the varying sentiments of traders, sometimes selling as low as $50, and at other times as high as $150, without any change whatever in the company's earnings, its prospects, or its management. (These matters will be dealt with a little farther on, and exemplified by showing their effects upon the mentalities of various types of speculators.) It does not follow that one who keeps in touch with the stock market by telephone, or through the daily papers, will find his path free from thorns and snares; but he will at least have a more open perspective than one who submits to the influence of the ticker.

Any intelligent trader may reason out exactly what he ought to do under certain specific conditions; but in the quickly shifting and uncertain process of determining values he loses his mental poise; and experience proves that anyone whose reasoning faculties become confounded is apt to be affected by some form of hysteria, and will frequently do the opposite of what he would do under normal conditions.

The most copious and the most unreliable financial writers are the market "tipsters" who write daily letters of advice to an army of subscribers, and claim to have more or less positive knowledge of what certain stocks or groups of stocks are going to do marketwise.

They often profess to have definite "inside information," which any subscriber may receive at a stated price, ranging anywhere from $10 a month upward. These false financial prophets, who lead a horde of blind followers, should not be confused with reputable bureaus and statistical experts who base their opinions and their advice to clients upon a logical analysis of general conditions.

Henry Fielding wrote a whole essay to prove that a man can write more informingly on topics of which he has some knowledge than on matters that he knows nothing about. He believed also that mankind is more agreeably entertained by example than by precept; therefore it is not the purpose of this discourse to teach anybody anything, unless perchance something may be gained by example or suggestion. There are four subjects on which advice, however good, is generally wasted, — politics, stock speculation, religion, and love; for in these matters grown-ups rarely follow the advice of others, and when they do, if they profit by it they take all the credit to themselves, whereas if they lose they always blame the adviser. Such are the in-


How to make money

exorable and universal laws of human nature.

Anyone may relate his own stock market experiences, or those of others — perhaps to the surprise or enlightenment of his audience. He may even venture his opinions on the subject; but for anybody to assume that he can continuously operate an unfailing system of making money on stock or grain exchanges would be equivalent to asserting that he could invert the fundamental laws of psychology, or that he could beat the game at Monte Carlo by scientific methods. Many have tried both, to their sorrow.

And still, hundreds of thousands of people continue to play at gambling tables, and hundreds of thousands speculate in stocks. There are many persons who gamble moderately all their lives, just as some drink moderately all their lives, with no resultant harm; while with others both of these inhibited practices become fixed and ruinous vices. Since trading in stocks has the appearance of being an easy way of making money, it is one of the most alluring pursuits of modern times; and from this very fact, although legalized for all, it is susceptible of becoming one of the most dangerous habits known. It is dangerous for the confirmed addict not only because he is apt to lose, but for the reason that it distracts his attention from business in daytime and frequently destroys his rest at night. But as it would be folly to advise people not to embark in commercial pursuits because statistics show that upwards of ninety per cent. of business ventures result in failure, so it would be useless to caution people not to trade in stocks because it is a hazardous undertaking in which a peculiar sort of sagacity and self-control are the only safeguards against certain disaster.

Most people of sturdy mentality are unwilling to admit that they could be made easy subjects of hypnotic influences, and would scout the idea that mere business transactions in securities could effect any undue subversion of their equipoise. The average human mind is, however, incapable of maintaining its equilibrium under the strain of great excitement; and no amount of knowledge, either inherent or acquired, no amount of experience, however dearly bought, will enable one always to think intelligently or act wisely under highly nerve-racking conditions. It is said that persons who become disoriented in a forest will almost invariably go in the wrong direction (I have done so myself on two different occasions); and that in an effort to salvage goods from a burning house they will throw mirrors and other fragile articles out a third-story window and carry pillows downstairs.

THE DISCONCERTING EFFECT OF SUDDEN LOSSES AND GAINS

There are but few things more unbalancing to the mind than the act of suddenly winning or losing large sums of money. A few years ago at Monte Carlo I was in company with a friend, a well known man of affairs who while there played at roulette nearly every day, merely as a pastime. He was of mature age, naturally methodical, conservative, temperate and cool-headed. He made it an unalterable rule to limit his losses to $200 at any one sitting, and on losing this amount he always stopped playing. His bets were usually limited to two dollars on the numbers, and never doubled except for one turn of the wheel when his number won. He generally played three numbers at a time; never more than four. For ten consecutive sittings luck was against him and each time he had lost his stake of $200. I saw him get up and leave the room, apparently in a state of disgust. An hour or so later I discovered him at a roulette table in another room stacking his chips in piles on a dozen or more numbers. Now and again when he exceeded the limit the watchful croupier reduced his bets and pushed a few disks back to him. In addition to betting on the numbers he was staking a thousand franc note on one of the three columns, another thousand on the colors, and a like amount on the center dozen. In one run he lost seventeen consecutive bets on red, of a thousand francs each. His eyes were bloodshot, his fingers twitched, and plainly he was under the strain of great agitation. He continued to play for three hours or so, when all of a sudden he got up, stood for a moment looking dazedly about, then left the table. He afterwards told me that he lost twenty thousand dollars; and that he hadn't the slightest recollection of anything that happened during the play, nor did he realize the amount he was betting. In this connection, it is a fact not generally known, that many rich men sign printed cards of instructions to the proprietor of a certain well known gambling club in the South, directing him to stop their play and refuse them further credit beyond a certain specified sum on any one day or evening of play, and refusing to become responsible beyond that amount. If men who trade in the stock market were to impose like restrictions upon their transactions the losses would in many cases be greatly minimized.

RETIRED BUSINESS MEN IN THE STOCK MARKET

Retired business men suffering from *ennui*, have often had recourse to the stock market as a means of stimulating their emotions and expanding their fortunes; with the result, in the first of these purposes they have usually succeeded beyond their expectations, while in the second they have met with uncharted obstacles. Some years ago when many of the great trusts were in process of formation a well known Pittsburgh magnate sold out his business to the United States Steel Corporation and later bought a home in New York and turned his attention to stock speculation. After plunging into a boiling market and buying thousands of shares at top prices, the trend eventually changed and he found himself on the crest of a tobogganing market with more than a hundred thousand shares of speculative stocks. At length when the pace threatened both his fortune and his peace of mind, in a fit of disgust he dumped his holdings overboard and proceeded to damn the market, the broker and everything else, including himself for being such an unlucky simpleton.

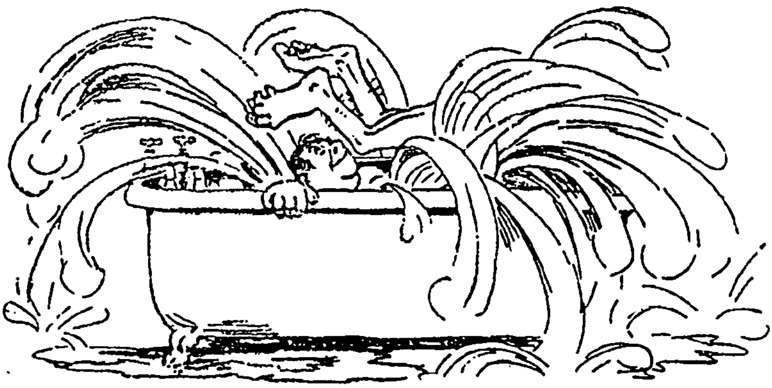
"My dear Mr. Blank," said his broker, "you are possibly quite justified in all your abuse, except that of yourself, to whom you really should apologize, since you do yourself a great injustice. You have had six months' experience in this game at an expense of a little less than two millions of dollars, whereas at the pace you began you were due to lose at least five times that amount but for your rare judgment and cool-headedness."

"But why in hell didn't you tell me all this before?" inquired the irate customer. To which the broker calmly replied, "It's my business to *take* orders; not to give directions to a man of your understanding."

When the American Hide and Leather Company was formed a number of years ago, a prominent Boston leather merchant of my acquaintance, sold his business to the new organization for a round million dollars in preferred stock and bonds, and in the course of the next few years of more or less restless inoccupation he devoted himself to a systematic study of investment securities and general stock market conditions. The panic of 1907, when values were almost entirely lost sight of in the mad scramble to liquidate stocks, afforded a rare opportunity to view the follies of reckless speculation, and our astute leather merchant was quick to observe the importance of this salutary lesson. The recovery that followed was almost magical, and many who bought stocks at the low prices doubled their money in a few months. Then following this sharp recovery there was the natural setback when speculators undertook to convert their new wealth into cash. And this too proved a wholesome lesson to our new apprentice in the game of high finance. For some years he had held to the conservative practice of investing only in non-speculative bonds, but this proved to be a slow and monotonous process of enlarging his fortune; furthermore it was devoid of the exciting thrills experienced by those who make fortunes overnight. He thought the funds of widows and orphans ought properly to be invested in gilt edge bonds and mortgages, but for a man of his business sagacity, in the prime of life, to content himself with merely cashing his coupons every six months was to decline into a state of innocuous desuetude — a condition into which he was determined not to retrograde. To launch one's bark into the rapidly shifting currents of fortune in the stock market and attempt to steer an even course is one of the surest preventives of *ennui*, and after deliberately weighing and analysing conditions from every conceivable angle our erstwhile leather merchant concluded that cutting a few coupons now and then was too tame an occupation for a man of his acumen and ambition. He informed his friends that after years of careful study of the "game," he was convinced that the reason why people lost, was that while in theory they all had the right ideas, they all used wrong formulas in practice. He declared that the "public," so-called, always "bought at the top and sold at the bottom" — a commonplace in stock market parlance, though not necessarily true. Also that the inclination of all speculators is to venture out beyond their depth, i. e., to buy more stocks than they can pay for, or protect by ample margin. This indiscretion he thought to be especially characteristic of those with but small capital, whose eagerness for large gains outstripped their conservatism and exposed them to the perils of abrupt and unexpected reactions and panics. He had never bought more hides and leather than he could pay for, either with his own funds or with money easily borrowed from banks; he would never buy more stocks or bonds than he could pay for, or protect with sufficient margin to carry them through the severest depression.

He was a self-made man; he had entered his firm as errand boy, and by sheer force of perseverance, ambition and intellect he rose steadily in usefulness and power until he became sole proprietor of the whole establishment. His prestige and the bulk of his fortune had been made in buying and storing goods when the markets were glutted and prices were low, and holding them till the markets were bare and prices were high. After accumulating large stores it sometimes required a year or more of patient waiting for the readjustment of trade conditions; but never had there been a time when during a given cycle, prices had not been abnormally low and also abnormally high. He reckoned his twenty-five years of this sort of training as a singularly qualifying element of success in buying and selling stocks. This undertaking, like dealing in hides and leather, required forethought, discretion, patience and courage. There was scarcely a two-year period in any decade wherein stocks in general could not be bought reasonably cheap; nor was there a similar period when at some time during the twenty-four months they could not be sold at fairly high prices. Statistics proved this to be almost infallibly true; statistics likewise proved that the preponderance of failures in his own line of business could be traced to injudicious purchases of large stores of merchandise at high prices, with resultant inventory losses. As a merchant he had learned that buying and selling leather and hides at a profit was a matter of forecasting future conditions in the light of past events; and as a student of stock market conditions he learned that a recovery of values *always* follows a prolonged slump in the price of stocks, and that sure success awaits those who pick the right psychological moments to buy and sell.

In due time this retired merchant secured a desk in a brokerage office and undertook to study the stock market systematically at close range, and to reduce some of his theories to actual practice. He did not launch into this new venture as one would plunge into a cold



bath; he patiently watched the action of the market from day to day, until stocks declined to a point where it seemed safe to begin buying on a scale down. Meanwhile he continued to study stock market charts and conditions — charts with double bottoms, double tops, pyramids and all such enlightening information — about past performances. At length he bought a few hundred shares of selected stocks, depositing bonds as margin — ample margin of fifty points or more. Prices reacted a little further, and in keeping with his motto, which was — "Buy on the decline, when the public is getting out, and sell on the rise when the public is getting in," he increased his holdings at every two or three points decline. In the course of time the market faced about, stocks began to recover, and in a few weeks he had the satisfaction of seeing his plans work out successfully in experiment, with a net gain of enough to cover interest on his investment for more than four years. According to precedent a temporary reaction was due; therefore, like most wary beginners, he sold out and cashed in his profits. In his exhaustive study of stock market psychology he had learned that while it is the practice of inexperienced traders to take small profits on stocks in a rising market, it is also their custom to buy the stocks back again at much higher figures, instead of waiting for prices to decline. This was one of the danger pits charted on his course of action; one of the many against which he had built up mental fortifications, strong enough in seasons of peace and calm, but in most people easily destructible by the baffling influences of stock market speculation.

Although a beginner in practice, he was a veteran in theory, for prior to entering the financial arena he had made hundreds of imaginary purchases and sales, nearly always at a profit. Moreover he had discovered that one may play both sides of the market, apparently with equal safety, and that the biggest "killings" are said to be made on the "short" side. By selling "short" on bulges and "covering" (i. e., buying the stock in to cover the sale) on reactions it was possible not only to make money both ways, but also to avoid the tedium of waiting inertly for opportune occasions to buy at bargain-prices. From the experience of others he derived a valuable lesson, namely, that investors and traders are always too eager to keep their capital constantly employed; that they are prone to hold stubbornly to one position, either long or short; and that the wellnigh irresistible impulse to get back into the market after selling out, whether at a profit or a loss, has probably been the ruination of more speculators than any other one cause. Playing the market both ways seemed a sure means of forestalling this error.