The meaning of capitulation

Money matters

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The investment industry uses some very descriptive words in describing investor behaviour and one of these is "capitulation".

This is the point when investors throw in the towel. Throwing in the towel is boxing speak for give-up.

Picture the towel in the air as the losing boxer's eyes glaze over and he staggers against the ropes, which is the only thing holding him up. The referee rushes in to stop the barrage of blows raining down on the soon-to-be loser as the winner senses victory. Blood, sweat and saliva flows freely as the noise level becomes deafening and the bloodthirsty crowd scream for the knockout.

You may ask what this has to do with investing. Well, nothing, other than that's kind of how I felt last week – like a rabbit in headlights knowing it won't going to end well. You'd think after 25 years in investing I would handle this better, but this is pure unadulterated fear.

Panic selling with no rational basis, whether it is the high velocity algorithm driven machines or active managers forced to liquidate their holding to pay-out panicking investors, the simple fact is when sellers are mass dumping their shares at any price there is no floor to how far and quickly the market can fall until it bottoms and low and behold, turns around as the sellers become buyers and prices recover.

Your classic V-shaped crash and recovery cycle, which happens all too often. We always think it is different this time because it is caused by a different trigger, which makes it scarier, but it is a normal fear/greed cycle on repeat.

When you invest in a share you get both price and value, but these are not always the same. Value represents the share of future company earnings and price is what you pay for this value at any given time.

However, during extreme periods of volatility, the link between price and value breaks-down. The price is not longer indicative of the value of underlying the business, but rather the irrational desire of sellers to sell at any price irrespective of the underlying value. Like any other commodity price is set by the buyers and sellers and if there are more sellers than buyers the prices will fall.

The stock markets efficiency and liquidity are its own downfall as investors can execute their irrational fear-based trades seamlessly, bringing instant relief to the pain felt from paper-losses incurred. It might sound ridiculous, but this pain is very real, behavioural scientists have done studies comparing the loss of a loved one to losses on the stock market.

As long-term rational investors we must accept crashes as normal stock market behaviour and learn to live with the temporary pain that comes with it. The risk is not a crash in prices, but how we behave when prices crash. If you cannot take the pain, then you must be honest with yourself and settle for a lower risk/return investment.

Having a rational headed financial adviser will also serve you in good stead and hopefully stop you from turning a temporary loss into a permanent loss by panic selling. As Warren Buffet said: "Investing is simple to understand, buy low and sell high, but not easy to do."
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