# Don't be driven by short-term sentiment and emotion

Arguably, the most common fear holding an investor back from achieving a great return is a misunderstanding of what happens when markets fall (as they invariably do).

In order to use fear to our advantage, we would be well served to seek to understand the following three principles around shares and their value:

- A share is simply a small slice of company ownership;
- A company's value ultimately depends on its present and future potential cash flows;
- Value may not always equal price.

Multi-billionaire and world's most successful investor, Warren Buffett, has defined investment as "the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future. More succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date."

In other words, it requires patience. Buying a stock (or house, or managed fund) and simply hoping the price goes up soon is, most certainly, not investing. While we may naturally feel emotions based on what the price does over this shorter term, history has shown it is vital not to let these emotions steer our financial decisions.

**Focus on quality and don't speculate**

A share is simply a slice of ownership in a business. For this reason, focus should be directed at the quality of the businesses and their prospects for the future, rather than a chart with a line that wiggles up and down as the price rises and falls.

Unfortunately, in the financial media, there is a clear focus on explaining short-term fluctuations in share price. Commentators often try to attribute every little rise and fall to a particular event or issue. The risk is that an investor may start taking their cues from price movements - which is driven by short-term sentiment and emotion, rather than value - which is ultimately driven by the cash flows a business generates now and into the future.

Benjamin Graham, often known as the 'father of value investing', famously said that "Price is what you pay, value is what you get." While the price of a share will certainly fluctuate, (sometimes multiple times per second, every day of the year!), the value of a company's future cash flows is likely to be far less volatile.

Speculation; ie: buying and blindly hoping that a price will go up soon, might be considered the antithesis of investing, and shouldn't ever be considered a safe strategy. Mark Twain once aptly mused that, "October is one of the most dangerous months to speculate in shares. The others are July, January, September, April, November, May, March, June, December, August and February."

If a share price falls sharply, yet the value of the business's future cash flow doesn't change, this may provide a wonderful opportunity to purchase further shares at a discounted price, hence maximising the potential return and reducing the potential for loss. A skilled fund manager will take advantage of this by applying this principle to a portfolio of businesses in order to further reduce risk to the investor through diversification.

Paradoxically, as an investor, your hope should generally be that prices fall in the short term. Volatility is the friend of the long-term investor.

That is not to say asset price volatility doesn't matter. For example, self-funded retirees being forced into selling units at a temporarily reduced price in order to fund their lifestyle isn't an attractive proposition. For this reason, financial planners commonly emphasise the importance of maintaining an adequate cash reserve - particularly in retirement.

Whether you are invested in a managed fund, direct shares or an investment property, price matters at precisely two times - when you buy and when you sell. The return on an investment depends on these prices and the distributions you receive over the investment period.

For these reasons, most quality fund managers will tend to remain focused on the fundamental prospects of the underlying companies owned, and think as a business owner rather than a 'stock picker'.

Source: AMP Capital