

One Thing Newton Unable to Calculate



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I am halfway to finish reading of Benjamin Graham's classic: *The Intelligent Investor*. The first edition of this text was published back then in 1950s. My husband bought the revised edition updated with new commentary by Jason Zweig, and now it is in my possession.

As I immersed myself flipping through the pages, a passage in the introduction caught my eyes. It was the narrative of Sir Isaac Newton losing GBP 20,000 in 1720s, equal to GBP 3 million in 1970s. It seems almost impossible that a person as smart as him can be such a dupe. But unfortunately, it happened.

It was the South Sea Bubble that made the Newton's flop so immense. At first, Newton started to put aside a portion of his fortune to invest in South Sea Company stock. The stock price went up, and Newton gleefully enjoyed a profit of GBP 7,000 from his stock trading. The thrill continued as the South Sea stock price roaring. Seeing this, Newton invested more money buying more South Sea stock at higher price in the hope to pocket a bigger profit. All hell broken loose, South Sea stock price nose-dove. Newton tried to exit only to occur such an irreversible loss.

Rumor has it, Newton once said that he could calculate the motions of the heavenly bodies, but not the madness of the people.

Not everyone putting money in the stock market can be called an investor, some of them may be just a speculator, almost akin to gambler. The main difference between investor and speculator is how they control their own madness ie. how to stay composed amidst stock market pandemonium. But, how?

“In most periods the investor must recognize the existence of a speculative factor in his common-stock holdings. It is his task to keep this component within minor limits, and to be prepared financially and psychologically for adverse results that may be of short or long duration.” (Graham, 2003, p. 20)

We must thoroughly analyze a company, and the soundness of its underlying businesses, before we buy its stock. Speculative factor is always there. However, it should be taken into consideration only after all the financial numbers are present. **First** thing to do is to look into all of the relevant financial information — the company's revenues all the way down into its net income, assets, liabilities, owners'

equity, cash flow, and equity statement. **Second**, look at the historical growth of the financial numbers. My husband use this one proxy while analyzing historical numbers: Was this company doing well fundamentally during the 2007-2008 financial crisis? **Last** thing, create a financial projection to answer this simple question: is this company going south? Actually, classic valuation approach (the one I learned from my undergrad class: P/E ratio and growth, FCF, EV/EBITDA) provides me a solid foundation to answer that question.

Sometimes, a minor speculative factor pops up when making a financial projection, especially related to technology stocks. This speculative factors include mergers & acquisition issue and stock price movement without any underlying basis. The key to keep this speculative factor within minor limit is to read a lot. I repeat, read a lot like hell every newspapers, books, financial statements, legit websites (such as Bloomberg, Morningstar, YahooFinance, etc.), and news in Google. I sometimes open as far as page 5 of Google search results to find hidden information that might be unpopular. The secret is, we do not need to create a financial projection from scratch. There are numerous analysts out there who have done the work and the results are posted online, accessible by paying a bit. We just need to find their analysis to slice and dice the information.

Controlling our madness is not only essential in stock market investing, but also in our practical daily life. Madness is one part which constitutes a great human mind but it can also drives our sanity away, making us do stupid things and unable to think clear. Alas, it is not easy to calculate madness of people, as Newton allegedly said. So for me, the easiest thing to deal with madness is to prepare ourselves with the stratagem to control our speculative mind — not letting madness consumes us.

God bless — I.A.C.