David Youngberg
ECON 201—Montgomery College

LECTURE 26: PERSONAL FINANCE & INVESTMENT

I. Reaction times
   a. Suppose some favorable news came out for a company. How long would it take for the stock price to change?
      i. A few seconds, depending on the nature of the information
   b. *Efficient market hypothesis* (EMH)—prices of traded assets reflect all publicly available information
      i. Note this doesn't mean the market is always right. Just that when it's wrong, there's no public information to suggest it's wrong.
      ii. If every tradable is valued fairly at all times, there's little point to trade frequently.
   c. Why do some people beat the market?
      i. *Luck*. With so many gambling, by chance you'll get a few that have won many, many, many times over
      ii. *Insider trading*. US Senators beat the stock market by an average of 12.3 percentage points (if the stock market's value grows by 3%, Senators' portfolio's value grows by 15.3%). House Representatives beat it by 6% and corporate insiders by 7.4%.[1]
      iii. *Psychology*. People panic. They succumb to overconfidence, group think, bubbles, etc. Those who can keep their head can profit.

II. Picking stocks
   a. Diversify: buy lots of different kinds of stocks to limit risk to any one area (this is also sometimes referred to as hedging your bet).
      i. *Buy and hold*—buying and holding stocks for the long run, regardless of what their short run fluctuations are.
   b. Avoid high fees: because stock picking is a fool's game, there's no reason to pay a lot for people to do it. But if you're doubtful of the EMH, maybe it's worth it. Maybe.
   c. Compound returns build wealth: A 4% annual rate of return means you will earn interest on the interest you earned in previous years. \$100 becomes \$104, then \$108.16, then \$112.49, then \$116.99, etc. This supports a buy and hold strategy.

---

[1] http://insidertrading.procon.org/view.answers.php?questionID=001034

    i. *Rule of 70*—Again, the Rule of 70 appears. To estimate how many periods it will take to double your money, divide seventy by your rate of return.
    ii. At 4% rate of return, you will double your money in 17.5 periods. Without compound interest, it would take 25 periods.

d. <u>No Return Without Risk</u>: Profit opportunities that are sure things are quickly bought up, reducing the return.
    i. *Risk-return trade-off*—higher returns come at the price of higher risk