Infomail

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Emotions in Motion

No Irrational Exuberance Yet

> "Fortunately, one of the most valuable lessons of my career came early in the 1970's, when I learned about the three stages of a bull market: the first, when a few forward looking people begin to believe things will get better, the second when most investors realize improvement is actually under way, and the third, when everyone's sure things will get better forever"
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> Howards Marks, US Investor and Writer

Coming off the best August in 14 years, where the S&P 500 hit the 2000 level for the first time in history, and the Nasdaq hit its highest level since 2000; you would think investors would be a happy lot. Instead, I would say overall, they remain pretty cautious and tentative.

I've learned that bull markets are not done once they hit defined valuation targets, nor do they stop just because a certain level is hit. Nor do they stop once market sentiment hits a certain level. I've learned the most intelligent money managers are the ones who will admit there is not certainty with respect to market cycles. The portfolio managers, pundits and advisors with the most certainty are usually the ones you should listen to the least.

It is impossible to know when a market cycle will end because the pendulum usually swings too far in one direction or the other. For every data point that shows an overvalued market you can find one that shows it fairly valued.

This is mainly because markets are emotionally driven. Extreme fear causes the pendulum too far to the sell side (like early 2009 for instance), and extreme greed causes it to swing too far on the upside (like the late 1990's). There are so many moving parts it's impossible to use a single variable or even a handful to tell you when the good times will end.

We've been inundated with crash calls for the last 4 years. This week on CNBC I heard one analyst call for a 60% drop in the S&P 500. Much of this negative bias is based on the fact that we've experienced two huge major market drops since 2000, so the reaction becomes Pavlovian. Some is plain fear mongering and ill-conceived, some are intelligent arguments about why the bull should have ended. Regardless, it hasn't mattered just yet.

One thing I do know, with respect to those indices I referred to earlier. The Nasdaq, which once dubbed itself "the stock market for the next hundred years" and is loaded with tech names in a world never so heavily invested in technology, has yet to get back to it's peak of 5048 hit way back in March 2000 (So over 14 years). The S&P 500 took over 16 years to gain 1000 more points after breaking the 1000 mark for the first time in 1998. Since the last peak of 1527 in March of 2000, the annualized return on America's biggest index has been a paltry 2.15%. Hardly any sign of an overvaluation given the S&P's 30 year return since 1983 was 11.09% annualized, and for the past 50 years was 8.2% (As an aside, Warren Buffet's return is 19.8% over that period, Carl Icahn's is 27%).

Investors get way too emotional and spend a lot of time trying to determine which year the current cycle resembles. Is this 1999 again? Or 2007? Or 1987? The fact is because of their emotions, investors actions are shaped by past experiences. So 2014 is just……2014. The constant is investor emotions that shape the market dynamics, especially over shorter time frames.

Does that mean because there's no "blood in the streets" that you sell all your equities because of the huge gains over the past five years? I guess that all depends on your time horizon and what kind of investor you are. Fed Chair Alan Greenspan himself thought the markets were way overvalued when he made his "irrational exuberance" speech in December 1996, yet markets continued to explode higher for over three more years!

Ideally, investors should have an equity portfolio in various investment themes. In part to take advantage of volatility but also resist the urge to close long term ideas too soon. Obviously the idea is to find names which are undervalued for the intermediate and long term; however it is easier said than done thanks once again to……emotions.

No matter what type of investor a person considers themselves, there is a psychological aspect to investing that triggers actions not originally intended. Losses will be taken from time to time and on the other side "greed" must be kept in check and be realistic.

The prediction game is perhaps the most disingenuous game of them all. Sure, we make predictions, but unlike many pundits, we are paid to give and provide an opinion. They are based on educated guesses that require a lot of research and over 30 years of experience. The disingenuous part I refer to is those who are always predicting the end of the world so if they do get it right once, they can write a book and go on the speaking circuit. In 1798 Thomas Malthus predicted overpopulation would lead to mass starvation. In 1968, Paul Ehrlich wrote a best seller called "The Population Bomb" warning the population boom would spark starvation and collapse, leaving 4 billion dead (including 65 million Americans). After Hurricane Katrina, we read from many "experts" who predicted a new normal with record breaking hurricanes every year.

We are still waiting.

Historically, markets enter bear territory every 3.5 years, so it stands to reason there is a good chance the negative pundits will get one right. But the people (and investors) who live their lives preparing for these "disasters" waste a lot of valuable time. "The Population Bomb" did sell over 2 million copies after all in the 1970's.

The trend of the US stock market indices for the past two years has been a steady bull trend with only token dips of 3-5% along the way.

There is a great case developing that we are in the midst of a structural bull market that could be only one-third to one-half completed. There is no doubt the US economy seems to be reaccelerating. Europe is still a mess, but getting better. Canada is steady. Emerging markets are picking up steam. China remains a question mark, but still growing at 7.5%.

Most equity corrections follow on the heels of excessive optimism. While there may be some complacency, excessive optimism is not the case. Earnings have been solid, not just on the bottom line, but on the top line (revenues) which is hard to manipulate. P/E ratio is 15/16X, which is at historical averages.

We have yet to see the traditional sources of cyclical excesses that have been precursors – overly optimistic hiring, excessive capital spending, indiscriminate merger-and-acquisitions, and huge IPO offerings. Maybe they are coming, but not yet.

While a modest pullback of 5-10% is certainly possible (and still never fun when they happen!), I think the overall situation is telling me a sectoral bull market is settling in. Patience can be a great equalizer of cycles in financial markets.

The bull market will end at some point, it will go down and a bear market will kick in. I just think it may be some time.

Stay tuned,

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