River Valley Asset Management

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It's not as bad as we think and it wasn't as good as we thought

That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so hot". But in the world of investing, perception often swings from "flawless" to "hopeless" – Howard Marks, founder of Oaktree Capital Management

In these times of extreme volatility, understanding the "psychology" of the market has become more important than focusing purely on the fundamentals. A similar exercise was carried out by Howard Marks the famous investor quoted above. His latest memos have dealt a good deal with this aspect of investing and we have used them as reference points to elaborate on this idea.

The "Swinging Pendulum" analogy

The markets' pricing mechanism (especially in the short term) is like the swinging pendulum. The mid-point of the arc is the equilibrium position (analogous to the fair value of a stock) but the pendulum hardly spends much time there. It spends most of its time in the arcs – either in the left one (like an undervalued market) or in the right arc (like an overvalued market). The only constant is that wherever the pendulum is, it will invariably swing back to the middle.

Continuing with our market analogy, markets over a longer period of time tend to move back towards the fair value (and overshoot on the other side). Hence buying below fair value is a reliable way to make money in the long term, though we agree that finding this fair value is not easy. On the other hand, buying something cheap ensures that you have a higher probability of being below fair value. Given the current state of the markets we focus on, we think a lot of assets are cheap.

More from Howard Marks

To further elaborate on our point about the importance of understanding market psychology, we have reproduced below a few quotes from Howard Marks's latest memo. These quotes are very helpful in not getting emotionally swayed in times like the present.

- The first quote relates to our point that understanding market psychology is important

"…That to be successful, an investor has to understand not just finance, accounting and economics, but also psychology."

- Multiple negatives have been building up over the past few years – structurally lower developed markets growth, reducing competitiveness of the developed world, reduced consumption growth by an over-levered consumer, the uncertain future of Europe, a global vacuum of quality leadership, the entitlement load from social security and medical services, China and its lopsided economy, turbulent geopolitics, etc. But the market has tended to ignore these negatives. The tipping point was however reached in August last year when the psychological mass of the market suddenly started focusing more on these negatives compared to the multiple positives it was focusing on earlier, though there was no actual change in fundamentals. Here Mr Marks says :

"One of the most notable behavioural traits amongst investors is their tendency to overlook negatives or understate their significance for a while, and then eventually to capitulate and overreact to them on the down side."

- We also tend to impute a lot more intelligence to the market, especially vis-à-vis its short term moves. We forget that though the market is relatively rational in the long term it is "manic – depressive" in the short term. Here is the quote from Mr Marks:

"Especially during downfalls, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously."

- This point relates to our "pendulum" analogy but is put in a slightly different way. Investors tend to focus too much on either the negatives or the positives. They rarely take a view that is a logical balance between the two. This is what Mr Marks says about this:

"One of the most significant factors keeping investors from reaching appropriate conclusions is their tendency to assess the world with emotionalism rather than objectively. Their failing takes two primary forms: selective perception and skewed interpretation (of both negative and positive inputs)."

"The bottom line is that investors' psychology rarely gives equal weight to both favourable and unfavourable developments. Likewise, investors' interpretation of events is usually biased by their emotional reaction to whatever is going on at the moment."

"First they exhibit high levels of optimism, greed, risk tolerance and credulousness, and their resulting behaviour causes asset prices to rise, potential returns to fall and risk to increase. But then for some reason – perhaps the arrival of a tipping point – they switch to pessimism, fear, risk aversion and scepticism, and this causes asset prices to fall, prospective returns to rise and risk to decrease."

- Emotion is an important source of error for most investors. Here Mr Marks says:

"Emotion is one of investors' greatest enemies. Fear makes it hard to remain optimistic about holdings whose prices are plummeting; just as envy makes it hard to refrain from buying the appreciating asset everyone else is enjoying owning".

- Another psychological mistake the market makes is to underestimate the second derivative impact of any large change. This could be on the negative side (as at the beginning of the sub-prime crisis in 2007-08) or positive (as could be the impact for the world economy from the drop in oil prices).

"The events that produced such extreme distress in late 2008 and early 2009 were unforeseen and unimagined just a few months before…even though the clues had been there for a year."

"The important thing isn't what the oil price decline tells us about today. It's what it says about tomorrow. And to me everything else being equal, I think low energy prices today will contribute to better economic growth tomorrow. Low prices today also probably imply higher prices eventually, through their impact on supply and demand. It's just that everybody is interpreting everything negatively these days".

Conclusion

In summary, it is important that we:

- Understand the importance of psychology and its influence on markets
- Control our emotions. *"An investors who is as subject as the crowd to emotional error is unlikely to do a superior job of surviving market swings"*
- Have control over our circumstances. Here we could include the impact from factors like high leverage leading to margin call induced selling, awareness of the inflows and outflows of other large funds in the market, pressure from short term performance targets, etc.
- Take advantage of contrarianism. This covers how we take advantage of other people's emotional swings. In layman's terms this means buying when people are scared and things are cheap and selling when people are euphoric and assets are expensive.

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