Market irrationality requires cool heads

Money Matters

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"*Be greedy when others are fearful and fearful when others are greedy*" – Warren Buffett.

The big financial institutions have just released their economic forecasts for 2018, and what do you know? They are extremely bullish, with a consensus view of global economic growth rates exceeding 3% next year.

This is important for investors, as economic growth ultimately underpins investment returns. However, there is empirical evidence proving there is no correlation between high economic growth and high returns. This may sound like a contradiction, or counter-intuitive to what you would have expected, but it makes sense if you understand investor behaviour.

Our own country is a very good example of this poor correlation between economic growth and investment returns.

SA has delivered excellent investment returns over the last 10 years on the back of lousy economic growth, conversely China has delivered poor investment returns notwithstanding phenomenal growth numbers.

The reason for this is that investors are prone to overpaying for a good story.

The better the story the higher the price. The underlying motivator is, of course, greed. For investors high prices translate into poor future returns, even when the good story unfolds as expected.

You have effectively paid upfront for the good news. As Warren Buffett puts it most succinctly, "you pay a high price for cheery consensus".

The best opportunity for investors is when the news is bad and expectations are poor. The motivator is, of course, fear. Prices are then low, reflecting the uncertainty and bad news, which is the perfect entry point for any investment. So simple, buy low and sell high, yet so difficult to execute owing to our investor behavioural biases, which are instinctively incorrect.

Most investors buy on good news and sell on bad news. Unfortunately this behaviour usually results in a poor investment outcome.

What makes this even more difficult is the fact that irrational market behaviour can get it wrong for a long time before correcting, and strangely, despite the obviousness of the consequences of mispricing (bubble). When it occurs only a few really notice and most investors are caught totally off-guard when the bubble bursts.

This is where patience is required from the rational investor, which is again not easy when everyone else is seemingly making money.

Without wanting to spoil the party, the phenomenal returns from global equities over the last few years, which is reflected in current high market valuations, does not bode well for future returns, notwithstanding the euphoria over global economic growth – in fact, because of it! – *www.markwilliams.co.za*