Please be more astute in reading the cycles

Money Matters

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As a 20-year-old backpacker hitchhiking through Europe I had planned to run with the bulls in Pamplona, Spain, but unfortunately I never made it to Spain.

But thinking back to my time as a fearless or stupid youngster this was probably a saving grace, as each year a few unlucky runners are badly hurt. But what does this have to do with investing?

I would like to use this story to explain the pitfalls of choosing or evaluating funds/managers based on recent past performance.

I have titled the article "Running with the Bulls" in reference to the risk of switching from an under-performing fund manager to last year's winner.

This is a classic behavioural finance bias error of selling cheap to buy expensive which, like unlucky Pamplona runners, usually ends in tears.

Stock markets are efficient at valuing assets over the long term and completely inefficient at doing the same through short-term cycles, which is why Benjamin Graham, author of *The Intelligent Investor*, referred to the stock market as a "weighing machine" over the long term and a "voting machine" over the short term, in reference to the irrational sentiment-driven mispricing of businesses during short-term market cycles.

Every business has an intrinsic value, which can be calculated based on earnings and earnings growth expectations.

However, the share price of the business may trade well above or below this intrinsic value, depending on investor sentiment. At times, when investors are positive they are prepared to pay too much for a business and, at times, when they are overly negative, they sell their shares at below actual value. It is during these sentiment-driven cycles, that astute investors are able to exploit mispricing opportunities to make money.

When evaluating a fund manager it is important to measure performance through a full cycle, either from peak to peak or trough to trough. The full cycle includes performance in the up and the down cycle. It is no good making a lot of money through excessive risk taking in the up cycle, and then losing it all in the down cycle.

Long-term out-performance comes from making money in the up cycle and then protecting the gains in the down cycle by limiting losses and recovering more quickly.

The current problem in defining short-term as a two- to three-year period versus long-term as five to seven years is that we are now nine years into a global bull market, post the market lows of February 2009.

In most investors' minds this is a long cycle and thus a true reflection of a manager's skills. But this is not so, as the up cycle is now gone and the true test of skill will be evident only after the next down cycle.

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