

Market sense and insanity

If your investment horizon is at least 3-5 years, short-term shocks should have little effect on holdings, with assets wisely allocated

INVESTORS are having it tough these days as they are bombarded with conflicting views from investment gurus from around the world. Just about anyone with some credentials is jumping onto the bandwagon to add more views just to further confuse the man in the street. The truth is, even the best and the brightest get it wrong sometimes. Consider the reported billions of losses suffered by the goliaths on Wall Street, as a result of the US sub-prime crisis.

Surely these giants have the financial resources to hire the best brains that money can buy, but look at the mess they have created! So much for the wisdom of this world.

The root cause of the current financial mess boils down to one word: greed. In the pursuit of profit, due diligence and accountability were put aside – and, as usual, the hardworking investors suffer the fallout.

In the past few months, we have had legends like George Soros and others who suggested that we could suffer the worst recession since the Second World War. Even if they get it right, they can still be wrong. Warren Buffet warned about the technology bubble in 1998 and he was absolutely right. However, he was watching everyone make tremendous profit from the dotcom craze while he made nothing. The bubble eventually burst only in 2000. What's more important than getting it right is to get it right at the right time.

Let's go back to basics. How do we make sense of economic fundamentals, market sentiment and values? Since last October, most major indices have corrected 15-25 per cent from their peak. Individual stocks have fallen even further. Take any blue (or bruised) chip in Singapore and you can see a 20-70 per cent correction despite it reporting record earnings.

In fact, the Straits Times Index (STI) is

MONEY MATTERS



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currently trading at close to the 1997-1998 crisis level. During the currency crisis, some tycoons in Indonesia were having breakfast as usual – but, by the end of the day, they were close to being bankrupt. Many companies went under and many people lost their jobs.

Today, besides our favourite chicken rice getting more expensive, what crisis are we facing? How do we justify valuations at crisis level?

Market sentiment is a powerful force in investment. Whether we acknowledge it or not, it influences market direction; after all, our decision to buy or sell is ultimately a reflection of our emotions and judgment. How then do we fit sentiment into our investment decision?

May I suggest that, in market extremes, be it at the top or bottom, sentiment plays a more dominant role in influencing investment decisions. It is at this juncture that fundamentals are thrown out of the window. In 2000, during the technology bubble hype, price/earnings (P/E) valuation of the S&P was at an unprecedented level, so much so that it exceeded the 100-year boundary.

In the past century, the P/E valuation ranges between 6x and 25x; at the peak of the technology bubble, it went to 35x. That was when we found many brilliant academics suggesting that valuation is unimportant.

Investors became so euphoric that they disregarded fundamentals and leaped into those technology stocks.

Conversely, in today's investment climate, many investors are gripped by fear, even though valuations are cheap by historical standards, interest rates are low and central banks are being very responsive in resolving the sub-prime and credit crisis.

What are the major causes of a deep recession in history? We can point out four factors:

- ◆ Policymakers committing serious errors. We do not see that today because global leaders are injecting funds and confidence back into the financial system.

- ◆ Real rates moving way above the economic growth rate. In general, interest rates are lower than growth rates in most countries.

- ◆ Valuations at bubble levels. Global valuations are considered decent to cheap by historical standards.

- ◆ Negative economic growth. The consensus from economic institutions is estimated global growth of 4.5 per cent.

As we look at causes of a major recession, there is hardly any evidence of a deep recession coming.

However, the global monetary and financial system is flawed, to begin with. Money is not backed by anything except the good name of the respective government. If one day the world does not believe in the system anymore, all hell will break loose and that's when we will suffer a systemic collapse. If we do not think this current crisis will lead to a systemic collapse, then investors should take advantage of this current opportunity and pick up assets with good value. If we have a systemic collapse, it does not matter what or where you are invested in. Your surest bet would be to hold gold, buy some land and take up farming.

How much more bad news is there? The

sub-prime losses are estimated to be between US\$500 billion and US\$1 trillion; so far, we have seen reported losses of around US\$300 billion. Rest assured that there are more skeletons hidden in the closet and they will eventually be exposed.

The good news is that we have a natural tendency to get used to bad news. Initially, investors will look towards bad news as a signal to sell. After a while, they will start to look at the bad news to sell and good news to buy. That is how plenty of volatility is created. Eventually, investors will only look out for the good news to buy and disregard the bad news. The stock markets will definitely bottom before the bad news ends.

As a recap, volatility in financial markets is caused by a myriad of factors – sub-prime meltdown, credit crunch, slowdown in the US economy, rising inflation, corrections in the Asian markets (think India and China), and sky-high oil prices.

Research has shown that bear market corrections typically last 8-9 months with a fallback of 16-20 per cent. Our observation shows that the correction which started last October has seen markets correcting in the range of 18-24 per cent. Even companies with strong fundamentals and earnings are being hit. However if your investment horizon is at least 3-5 years, the short-term shocks should have little effect on your holdings, provided you had allocated your assets appropriately.

The pressing question on a retail investor's mind now is: What should I do going forward – should I stay invested or should I exit? Answer: If you have a three-year investment time horizon and you can stomach the volatility, stay invested. If you are losing sleep because of your investments, stay out and sleep well.

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