QV Update

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Driving in the Fast Lane with the Rear View Mirror

The economy has been improving. US manufacturing data has shown robust expansion since the summer. Nondefense factory orders have reached all-time highs. So has the For-Hire Truck Tonnage Index. The yield curve remains steep. Unfortunately these data points offer little insight into future stock returns. The stock market is a discounting mechanism – it leads the economy. As such, 2013's returns likely represented the market factoring in better growth and lower uncertainty.

More importantly, economic growth can have little effect on stock market performance over considerable periods of time. Consider this: From 1964 to 1981 US Gross National Product (GNP) grew by 373% while the price return of the Dow Jones Industrial Average (DJIA) was 0%. From 1981-1998 however, GNP grew by only 177% but the DJIA gained 949%[1]. Clearly other factors were at play. In both cases there were three: interest rates, corporate profitability and psychology[2]. During the first period, interest rates on long term government bonds rose from 4.2% to 13.65%. During the second period, they fell back to 5.09%[3]. As has been said before, interest rates act as both gas pedal and brake for asset price levels. Indeed. Meanwhile expectations for future profitability were low in the first period – by the early 80's restrictive Fed policy had driven profitability to the lowest level since the 1930's[4]. In the second period, profitability bottomed and then increased substantially. Finally, there was the role of psychology. In reaction to strong returns in the second period, speculative activity exploded, driving markets further. This factor was much less apparent in the first period.

The interplay of psychology and stock markets can be an important determinant of returns. In Charlie Munger's essay 'The Psychology of Human Misjudgement', the author describes how errors in cognition and decision making can arise from behavioural responses to stimuli and contrast based perception. Mr Munger elaborates on the limits of behavioural tendencies using an example seen in ant colonies. Ants have behavioural algorithms hard wired into their nervous systems that cause them to respond to a number of stimuli. This feature makes them a very effective social species but it also has its limits. For example, when an ant dies in the hive it releases a pheromone stimulus. Other ants detect this and respond by collectively removing it from the hive. This is an effective social behavioural response for the well-being of the colony. However if that same pheromone is sprayed on a living ant, its peers will remove it nonetheless. Here we see a useful behavioural algorithm gone awry. Humans also possess a number of behavioural traits, which although effective evolutionary tools, also have their limits. Even our perceptions, when faced with contrasting stimulus can prove erroneous. For example, if you place one hand in a bucket of hot water and the other in cold, wait a minute and then place both hands in room temperature water, the room temperature water feels hot to the one that had been in cold water and cold to the one that had been in hot water. A fun experiment perhaps, but it demonstrates the limits of our perception when faced with contrasting stimulus.

Unfortunately human cognition is often no different and investors tend to be afflicted with similar limiting behaviours and perceptions. A response of particular detriment is reacting to a new environment based on the conditions of the past environment. For example, in 1971 private pension funds allocated 91% of their cash flow into stocks. After the market crashed in 1974, this number fell to 13% even though stocks were then much cheaper[5]. Here it seems that pension funds had erroneously extrapolated the weak returns of 1974 into the future. Since the Financial Crisis of 2008, private pension funds' allocation to equities have remained at multi-decade lows while retail investors have heavily purchased bonds at the expense of stocks. However, in the last 12 months and after almost 5 years of great stock returns, retail investors have embarked on a wave of equity purchases with an eye firmly fixed on strong market returns of the recent past.

Reflect on where we are today. The economy is improving. Interest rates are low and rising but won't likely weigh significantly on asset prices until much higher levels. Corporate profitability is at an all-time high but may remain stable given continuing excess capacity. All positives, but valuations are growing rich. Further, the incidence of cognitive error in investor behaviour appears to be rising. This can be a powerful but ultimately ephemeral driver of markets. To be sure there are a lot of reasons that the good times can keep on rolling. But don't be fooled, the easy money has likely been made. As more and more investors seem to be driving with their eyes on the rear view mirror, the chance of collision is rising.

[1,2,3,4,5] Warren Buffet on the Stock Market, CNN Money, 12/10/2001.