

Myths and mistakes investors often make



Introduction

Given the complexity of investment markets and investing, along with the massive amount of information available to investors, many people rely on logic based on 'common sense' or simple 'rules of thumb' in making investment decisions. However, while some rules of thumb are reasonable, in many cases they are not and can result in investors missing opportunities or losing money. In this note we look at some of these and why they are unreliable.

Myth 1: High unemployment will prevent an economic recovery

This argument is wheeled out every time there is a recession. If it was correct then economies would never recover from a recession. Rather, they would spiral down into the sort of crises that Karl Marx predicted would ultimately lead to the demise of capitalism. Of course, this does not happen. Instead, the boost to household discretionary income from lower mortgage bills, tax cuts and stimulus payments eventually offsets the fear of unemployment for the bulk of people still employed. As a result, they eventually increase spending, which in turn stimulates the economy. In fact, it is normal for unemployment to continue rising during the initial phases of a recovery as businesses are slow to start employing again, fearing the recovery will not last. Since share markets normally lead economic recoveries, the peak in unemployment often comes a long time after shares have bottomed. In Australia, the average lag from a bottom in shares following a bear market to a peak in the unemployment rate has been twelve and a half months.

Shares normally lead the peak in unemployment around recessions

Australian recessions	Associated bear market in Australian shares	Peak in Australian unemployment rate	Share market low versus unemployment peak. Months before (+)
Early 1930s	Jul 1929 – Aug 1931	June 1932	+10
Early 1950s	May 1951 – Dec 1952	June 1953	+6
Early 1960s	Sep 1960 – Nov 1960	Sep 1961	+10
Mid 1960s	Feb 1964 – Jun 1965	Sep 1967	+15
Early 1970s	Jan 1970 – Nov 1971	Sep 1972	+10
Mid 1970s	Jan 1973 – Sep 1974	Dec 1975	+15
Early 1980s	Nov 1980 – Jul 1982	Jul 1983	+12
Early 1990s	Aug 1989 – Jan 1991	Dec 1992	+23
Average			+12.5

Table only shows those episodes where a recession was associated with a bear market in shares and vice versa. Based on All Ords.

Source: Bloomberg, Thomson Financial, AMP Capital Investors

Myth 2: Business won't invest when capacity utilisation is low

This argument is also rolled out during recessions. The problem with this myth is to ignore the fact that capacity utilisation is low in a recession simply because spending – including business investment – is weak. When demand increases, profits improve and this drives a pick-up in business investment which in turn drives up capacity utilisation. Therefore, while business investment in key countries right now is poor, providing there will be a pick up in demand – and several indicators are pointing to such later this year – then business investment will start to improve even though many factories are still idle.

Myth 3: Corporate CEOs, being close to the ground, should provide a good guide to where the economy is going

Again this myth sounds like good common sense. However, senior business people are often overwhelmingly influenced by their own sales figures but have no particular lead on the future. In the late stages of the early 1980s and early 1990s recessions, anecdotal comments from Australian CEOs were generally bearish – just as recovery was about to take hold. Note this is not to say that CEO comments are of no value; but they should be seen as telling us where we are rather than where we are going.

Myth 4: The economic cycle is suspended

A common mistake investors make at business cycle extremes is to assume that the business cycle won't turn back the other way. After several years of good times it is common to hear talk of 'a new era of prosperity'. Similarly, during bad times it is common to hear talk of 'continued tough times'. But history tells us the business cycle is likely to remain alive and well.

Myth 5: Crowd support for a particular investment indicates a sure thing

This 'safety in numbers' concept has its origin in crowd psychology. Put simply, individual investors often feel safest investing in a particular asset when their neighbours and friends are doing so and the positive message is reinforced via media commentary. The only problem with this is that while it may work for a while it is usually doomed to failure. The reason is that if everyone is bullish and has bought into the asset there is no one left to buy in the face of any more good news, but plenty of people who can sell if some bad news comes along. The opposite applies when everyone is bearish and has sold – it only takes a bit of good news to turn the market up. As we saw in March this can be quite rapid as investors have to close out short positions in shares. The trick for smart investors is to be sceptical of crowds rather than drawing comfort from them.

Myth 6: Recent past returns are a guide to the future

This is another classic mistake that investors make which is again clearly rooted in investor psychology. Reflecting the difficulty in

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processing information, short memories and wishful thinking, recent poor returns are assumed to continue and vice versa for strong returns. The problem with this is that combined with the 'safety in numbers' myth it results in investors getting into an investment at the wrong time (when it is peaking) and getting out of it at the wrong time (when it is bottoming).

Myth 7: Strong economic growth and strong profit growth are good for stocks and poor economic growth and falling profits are bad

This is generally true over the long term and at various points in the economic cycle, but at cyclical extremes it is usually wrong and constitutes another big mistake investors make. The problem is that share markets are forward looking. When economic data is really strong the market has already factored it in. In fact, the share market may then start to fret about rising cost pressures and rising short-term interest rates. As an example, when global share markets peaked in around November 2007, global economic growth and profit indicators looked good.

Of course, the opposite occurs at market lows. For example, at the bottom of the last bear market in shares during March 2003, global economic indicators were very poor and the general fear was of a 'double dip' back into global recession. As it turned out, despite this 'bad news', stocks turned around with better economic and profit news only coming along later in the year to confirm the rally. A similar situation may be occurring right now with gross domestic product (GDP) figures worldwide confirming the worst global recession since the 1930s. Unemployment is also rising, yet share markets have been moving higher for the last three months. History indicates time and again that the best gains in stocks are usually made when the economic news is poor and economic recovery is just beginning or not even evident.

Myth 8: Strong demand for a particular product produced by a stock market sector (eg housing) should see stocks in the sector do well and vice versa

While this might work over the long term, it suffers from the same weakness as Myth 7. That is, by the time housing construction is really strong it should already be factored into the share prices for building material and home building stocks. Thus the market may start to start to anticipate a downturn.

Myth 9: Budget deficits drive higher bond yields

The logic behind this is simple supply and demand. If the Government is borrowing more then this should push up interest rates and vice versa. However, it often does not turn out this way. Periods of rising budget deficits are usually associated with recession and hence weak private sector borrowing, falling inflation and decreasing interest rates. In this case, bond yields actually fall, not rise. This was evident in both the US and Australia during the early 1990s recessions and in Japan through the 1990s. While surging public sector borrowing around the world has contributed to a rise in bond yields this year, reduced 'safe haven' demand as investor confidence has stabilised may be the main factor. It remains to be seen how bond yields will behave as the rising level of excess capacity globally puts further downwards pressure on inflation as normally occurs in the aftermath of a recession. History suggests bond yields might head lower again.

Myth 10: Having a well diversified portfolio means that an investor is free to take on more risk

This mistake has been clearly evident in recent years. A common strategy has been to build up more diverse portfolios of investments that are less dependent on equities and with greater exposure to alternatives such as hedge funds, commodities, direct property, credit, infrastructure, timber, etc. This generally led to a

reduced exposure to truly defensive asset classes like government bonds. In effect, investors have been taking on more risk helped by the 'comfort' provided by greater diversification. Yes, there is a case for alternative assets. But unfortunately the events of the last two years have exposed the danger in allowing such an approach to drive an increased exposure to risky assets overall. Apart from government bonds and cash, virtually all assets have felt the blow torch of the global financial crisis, with agricultural investments being the latest victim in Australia.

Myth 11: Tax should be the key driver of investment decisions

For many, the motivation to reduce tax is a key investment driver. But there is no point negatively gearing into an investment to get a tax refund if it always makes a loss. Similarly, the recent experience with Managed Investment Schemes also highlights the danger in relying too much on tax considerations to drive investments. The first priority is to make sure that an investment stacks up well in its own right – without relying on tax considerations.

Myth 12: Experts can tell you where the market is going

Economic and investment forecasts are often seen as central to investing. It is well known that when the consensus of experts' forecasts for key economic or investment indicators are compared to actual outcomes they are often out by a wide margin. This was particularly the case last year. Forecasts for economic and investment indicators are useful but need to be treated with care. Like everyone, market forecasters suffer from numerous psychological biases. Also, quantitative point forecasts are conditional upon information available when the forecast is made and need adjustment as new facts come to light. If forecasting the investment markets was easy then everyone would be rich and would have stopped doing it. The key value in investment experts' analysis and forecasts is to get a handle on all the issues surrounding an investment market and to understand what the consensus is. Experts are also useful in placing current events in their historical context and this can provide valuable insights for investors in terms of the potential for the market going forward. This is far more valuable than simple forecasts as to where the ASX200 will be in a years time.

Conclusion

The myths cited here might appear logical and consistent with common sense, but they all suffer often fatal flaws which can lead investors into making the wrong decisions. The trick to successful investing is to recognise that markets (and economies) are highly complex, that they don't go in the same direction indefinitely, that markets are usually forward looking and that avoiding crowds is healthy.

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