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The end is nigh, or is it? Try to turn down the noise

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Key points

> A combination of the blanket news coverage of economic worries, the associated information avalanche we are now exposed to and our innate fascination with crises is likely making us worse investors: more fearful, more jittery and more focussed on the short term.

> Investors should recognise that shares climb a wall of worry, try and turn down the "news" volume, focus on investing for the long term, and remember the best time to invest is when everyone is gloomy.

Introduction

About two months ago I had all my wisdom teeth out - well rather the top teeth were pulled and the bottom teeth chopped off. The day this was to happen a speed test I was running on my iPad was interrupted by an ad screaming "The Australian Recession of 2014: why it's inevitable, click here to find out how to protect your wealth" (for a fee) and the headline on the front page of the AFR was "Economy enters the danger zone". Needless to say all this gloom did nothing to cheer me ahead of the trip to the dentist!

This year has seen an endless list of worries. Ukraine, a property collapse in China, the end of quantitative easing and talk of rate hikes in the US, global deflation, renewed weakness in Europe, the Insurgent Savagery (IS) in Iraq, protests in Hong Kong, Ebola, Australian Budget cutbacks, the collapse of the iron ore price, etc.

But last year was the same with the US fiscal cliff, worries about Italy and Spain, Cyprus (remember how the bailout of Cypriot banks was going to destroy the European banking system!), the sequester, Fed taper talk, Syria, the US Government shutdown and debt ceiling, Fed tapering, etc.

2012 was just as packed with worries – remember the one about the end of the world according to the Mayan calendar that was going to happen on December 21. I actually went to sleep that night with fingers crossed fearing the end was nigh, woke up the next morning with relief only to realise that if the world was to end it would surely happen in the US time zone so as to make the movie. And even then it didn't end!

Going by much financial commentary and the questions I get from investors it seems there are lots of things about to drag us into the next financial crisis: budget deficits, debt, money printing, the Euro, hyperinflation, deflation, taxes, welfare spending, banks, retiring baby boomers, the government, Obamacare, peak oil, pollution, global warming, war in the Middle East, terrorism, Russia, China, a pandemic. The expected result is always horrible with a massive loss of wealth, rising unemployment and maybe even the collapse of civilisation.

The perpetual worry list and the ongoing doom and gloom has me wondering. Is there anything new in this? Why the fascination with doom and gloom? And is the avalanche of economic and financial information we are now seeing with the IT revolution making things seem worse?

Worry, worry, worry – but nothing new

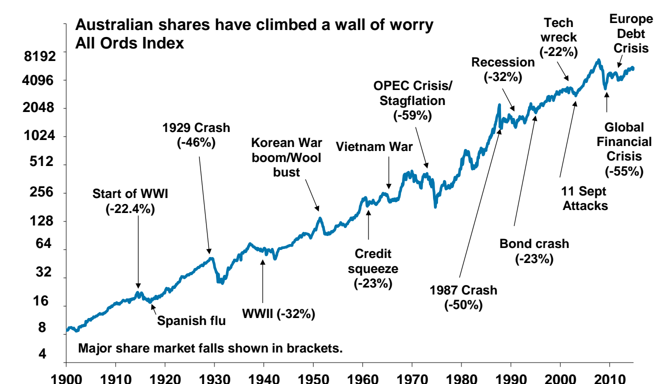
While not to deny the current worry list, it's really nothing new. The global economy has had plenty of difficult phases in the past. And it got over them. Here is a list from the last century. 1906 San Francisco earthquake; 1907 US financial panic; WWI; 1918 Spanish flu pandemic (up to 50 million killed); The Great Depression; WW2; Korean War; 1957 flu pandemic; 1960 credit crunch; Cuban missile crisis; Vietnam War; 1968 flu pandemic; 1973 OPEC oil embargo; Watergate; stagflation in the 1970s; apparent death of Elvis in 1977; Iranian revolution/second oil crisis; Latin American debt crisis; Chernobyl nuclear disaster; 1987 share crash; First Gulf War; Japanese bubble economy collapse; US Savings and Loan crisis; Second Gulf War; Asian crisis; Tech wreck; 9/11 terrorist attacks; Lehman Brothers collapse; and the Eurozone public debt crisis.

And prognostications that the world is about to bump into a physical limit, causing some sort of "great disruption", have regularly been made over the last two hundred years. Thomas Malthus, Paul Ehrlich's The Population Bomb of 1968, the Club of Rome report on the Limits to Growth in 1972, the "peak oil" fanatics who keep telling me I will have to ditch the Holden and get a horse and buggy, etc. Such Malthusian analyses dramatically underestimate resources, the role of price increases in driving change and human ingenuity in facilitating it.

And when you're reading books like those from Harry S Dent about The Great Depression Ahead (2009), The Great Crash Ahead (2011) and The Demographic Cliff (2014) just recall that there has long been a particular fascination with "the coming financial crisis". Google those words and you'll find 37 million search results including: 8 reasons why a new global financial crisis could be on the way; How to deal with the coming economic crisis; The coming "tsunami of debt" and financial crisis in America; The next big crisis? Think 2008 only worse; and Why you will be blinded by the next financial crisis. Yeah right!

Amongst my favourites are Ravi Batra's The Great Depression of 1990, well that didn't happen so it was just delayed to The Crash of the Millennium that foresaw an inflationary depression which didn't happen either. No worries. The point is usually to scare enough people into buying the books and make millions in the process!

And yet despite this litany of problems and continuous prognostications of doom, since 1900 US shares have returned 9.8% per annum (or 6.5% pa after inflation) and Australian shares 11.9% pa (or 7.8% pa after inflation).



Source: ASX, AMP Capital

It could be the world is more problematic than it used to be, but this seems doubtful. When I think of what my parents went through – Great Depression, infant sibling deaths, wars and severe recessions – I find it hard to agree life is harder today.

Or does it just seem that way?

I can't deny that there are things to worry about – and the money that can be made from promoting them. But I wonder whether the communications revolution we are seeing combined with human nature are making them seem worse than they really are? Information technology is great – but we are now bombarded by economic and financial news and opinions on a continuous basis via TV with finance updates, multiple news and finance channels, websites and blogs, twitter, or wrapping around a building.

The reality though is that much of this financial news is noise – random moves in economic data more due to statistical aberrations than fundamental swings in the economy, gyrations in share prices and currencies that reflect swings in sentiment on the day, constant chatter about what it all means. And of course it's well known that "bad news sells". Do you ever wonder why we hear when a 1% fall in the shares wipes $16bn off the share market but not when a 1% rise adds $16bn?

But why does bad news sell? Perhaps the answer is that the human brain evolved during the Pleistocene age when the trick was to avoid being squashed by a wholly mammoth or eaten by a sabre tooth tiger. And so we are always on the lookout for risks.

This probably partly explains a couple of other things. First it's long been observed that investors suffer from myopic loss aversion, ie a loss in financial wealth is felt much more distastefully than the beneficial impact of the same sized gain.

And secondly, as John Stuart Mill observed negative thinkers are more likely to be revered than positive. "I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage." It invariably seems that higher regard is had for pessimists predicting disaster than optimists seeing better times. As JK Galbraith once observed "we all agree that pessimism is a mark of a superior intellect." It seems that the human mind has been hard wired to always be on guard and so naturally attracted to doomsayers.

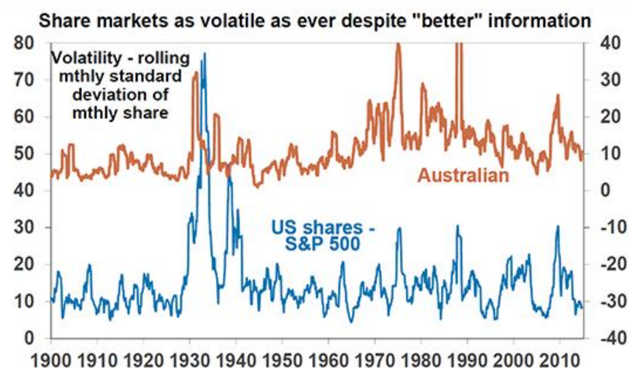
So talk of gloom and doom more readily finds a market than balanced commentary, because it appeals to our base instinct to look for risks around the corner.

The reality is that much of the noise around investment markets is nothing more than a soap opera. So much is going on and it's invariably bad. An ordinary investor could be forgiven for thinking we are in a constant state of economic crisis, lurching from worrying about one potential catastrophe to another.

Help or hindrance

In theory the access to information that has come with the information and communications revolution has made us all more informed and surely this means investment markets should be more efficient than ever resulting in a better allocation of resources resulting in stronger long term growth and profits. And hence better returns for investors. However, sorry to disappoint but there is no sign of this.

To be sure, new information is now more quickly reflected in financial markets. But it's hard to see any evidence that all the extra information is resulting in more rational pricing of shares and currencies. Financial markets are as volatile as ever. And we are still beset by periodic asset bubbles and busts. The next chart shows volatility in Australian and US shares is basically in the same range it's been in over the last century.



Source: ASX, Global Financial Data, AMP Capital Investors

And there is no evidence of consistently higher returns for investors. Individual investors may even be worse off. Faced with a constant barrage of mostly negative news and worries, the distaste investors have for loss causes them to shorten their investment horizons and become excessively cautious, which means they are less likely to take risks which will ultimately mean lower long term returns.

And perhaps even more worryingly, the greater short term focus is arguably boosting short term "speculation" relative to medium to longer term "investment" in the economy which may adversely affect economic conditions and prosperity.

Put simply, there is a risk that the combination of the blanket coverage of worries via constant news, the associated information avalanche we are now exposed to and our innate fascination with crises is making us worse investors: more fearful, more jittery and more focussed on the short term. And this is bad for investors and bad for the economy.

What does it mean for investors?

Given all this there are four things investors should do.

- First, recognise that shares and other growth assets have historically climbed a wall of worry and they will most likely continue to do so. Yes there are always lots of worries out there. Sometimes they become real concerns but most of the time they come to nothing. In fact since 1900 Australian shares have risen 8 years out of ten.
- Second, turn the volume down on the "news" front, ie consume less of it. You'd be better watching less of the financial soap opera in favour of episodes of The Brady Bunch or The Partridge Family.
- Third, adopt a long term strategy and stick to it. The environment we are now in has increased the importance of asset allocation – but this is best left to experts and those who can really put the time in to filter the noise from fundamental signals. Most individual investors will end up getting it wrong so the best approach is to agree a long term strategy and stick to it.
- Finally, recognise that the best opportunities in investing often arise when many are engulfed by gloom and doom and the market is cheap.

And just a thought on forecasting

For those who think I am being a bit harsh on the prognosticators of doom, I will be the first to admit I have had a few misses too. My first manager used to say "forecasting is hard because it concerns the future" which sounds inane but it's fundamentally true. But the key is to maintain historical perspective, realise that yes bad things do happen, and that all experts can be wrong at times (including me!), but that most of the time things turn out okay for the economy and growth assets. I think it's better backing that than the 20% or so chance that they won't.

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