

Rational Investing in an irrational World

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From fear to euphoria in one month ? The last couple of weeks we had the steepest U.S. stock market rally in over 70 years.

As we contemplate the investment outlook post Sub-prime global stock market crash, it pays to look back and remember that financial markets have an incredible capacity for reacting to news and economic developments in a way that confounds market professionals and retail investors alike – the only difference being the latter will admit to being confused, while the former will quickly come up with a few dusty rationalizations.

Our sell-side friends at many Wall Street banks now preach that it is time to buy cyclical stocks as the worst is over. More independent minded investors like George Soros or Marc Faber warn the market got ahead of itself and that a correction of at least -10% is highly likely.

Economist John Maynard Keynes put it best when he remarked: “Nothing is more suicidal than a rational investment policy in an irrational world”. In the long-run, true value is always revealed but in the short-term, the market and individual stocks and bonds get pushed and pulled by a variety of forces – portfolio re-balancing, rumours, news, investment fads, seasonal tendencies – that have nothing to do with fundamentals. Lord Keynes also remarked that: “In the long-run we are all dead and in the short-run you get a margin call”.

Monitoring economic reports is a very important but overlooked area of trading and investing. Nowhere are the advantages and drawbacks of a Blackberry world of instantaneous electronic communications more evident than in the financial markets. A long-term price trend might seem obvious or inevitable in retrospect, but in the short-term, markets are pulled and pushed by a never-ending stream of “news” like economic reports, statistics and earnings. As the speed and range of market news has increased, so has the challenge of interpreting it – or more accurately, managing the market’s reaction to it. When deciphering economic indicators and market news, it is important to understand that in Alice of Wonderland world of global financial markets, bad news can be good news and good news can be bad news. The economic context in which a news report is released is the key to resolving these paradoxes.

Correctly anticipating the impact of such news, rather than the news itself, is one of most useful skills of the accomplished investor. In financial markets, the impact of the data is not always what it should be (or what we think it should be). What initially appears to be a “bad number” is sometimes followed by a rally of steady buying.

Similarly, a report that seemingly underscores economic strength may be met by frantic selling. Investors who have learned to survive and prosper in the markets use this flow of information to form intelligent expectations about the market's chances / probabilities of trading up, down or sideways. The macroeconomic flow also plays a key role in determining individual sector trends: Is it time to rotate out of Telecom stocks into banking stocks ?

Having said that, when it comes to macroeconomic news reports that rock the market, the most important thing is to understand that it is not the number itself that counts but rather what expectation has been built into the number and how the market reacts to it. When contemplating how an economic report may affect the market, there are three crucial points to keep in mind. First, all indicators are not created equal. Second, the news is not always what it seems and third, context is king.

To better understand the often confusing reactions to economic data, remember three points:

- Sometimes bad news can be very good news
- First impressions do not always last
- Only deviations from expectations truly move the market

Investment management is an art, more than a science. The broader point is that in assessing the market's reaction is much more a complicated game of chess than simple checkers. The picture is always changing. It comes into play when expectations about the future have a bearing on present behavior – which is the case in financial markets. Some mechanism must be triggered for the participant's bias to affect not only market prices but the so-called fundamentals which are supposed to determine market prices. The fundamentals that you read about in newspaper or research reports are usually useless as the market has already discounted the price. However, if you caught them on early before others, then you might have a valuable “surprise- a-mentals”.

When it come to investing, Albert Einstein's immortal words of: “Imagination is 10 time more powerful than knowledge” holds very true. A good investor can not be rigid. If you can find someone who is really open to seeing anything , then you have found the raw ingredients of a good investor and/ or investment advisor.

When news comes out, the market should act in a way that reflects the right psychological “tone” or sentiment. Technical analysis gives an investor valuable information, fundamentals give an investor valuable news. Fundamental analysis creates what might be called a “reality gap” between what should be and what is. So am I bullish or bearish right now ? I don't know. My goal isn't to be either – it is to pick up good risk / reward situations. I remain open minded and flexible. Operate at the edge of order and chaos but preserve your own investment style. The past is fixed and easy to analyze. The future is fluid and uncertain. You have to base your decisions on probabilities in an atmosphere of uncertainty.

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