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THE VIEW
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Taming the beasts of bias

Investors run the risk of losing their perspective of where they are in an investment cycle, especially when caught in an environment of familiarity

When you are in the forest, it is difficult to see the trees.

The noise is deafening and you lose your bearings. When this happens as investors, we can fall prey to such jungle beasts as situation framing and familiarity biases, and we lose perspective of where we might be in the investment cycle.

Behavioural finance theory tells us that it is very easy for us to become framed or boxed in with our thoughts – comfortably cocooned within a familiar environment. It becomes very difficult for us to think laterally about where we are in the market cycle.

One of the best ways to break this is to look at the markets over a very long period.

Most of us can remember one cycle from boom to bust and back to boom again. It gets harder to remember the lessons that several ups and downs teach us.

This length of time between peaks recently is around seven years; the seven-year itch referred to in previous columns. It is not an optimistic indicator to recall that the last bull market ended in October 2007.

In order to cut free of the short-term familiarity and framing bias jungle it is useful to go back in time. An excellent proxy for the equity asset class is the MSCI World index and a review of the past 40 years enables us to see how the fantastic bull cycles performed.

The Reagan/Thatcher deregulation and bull market of the 1980s showed what politicians can do for the global economy, and stock markets.

It was the greatest bull surge of all time, beginning in August 1982 and ending with the October crash of 1987. The market rose 314 per cent in 72 months, a rise of over 4 per cent per month and, naturally, the crash came a year into my new job with a stockbroker in London.

Investors must look at stock trends over a long period. Photo: AFP

That bear market, a fall of 20 per cent was but short lived, and heralded a period of slow growth until 1993 began the dotcom bubble. This ended in March 2000 with the index up 188 per cent in 86 months, a rise of some 2 per cent per month.

> **What has not gone up is unlikely to go down much more**

The liquidity bubble, where we borrowed far too much owing to far too low interest rates, began in March 2003. As we know, that one ended in October 2007 with the global financial crisis, a rise of 136 per cent in 55 months (2.3 per cent).

That crisis nearly bust the world economy and deflated many a self-appointed Master of the Universe. It is sobering to think that the current rally from March 2009 has led to a rise of 154 per cent in 43 months, a rise of some 3.5 per cent, making it the second biggest rally – so far – in the history of the modern global economy.

On the other hand, equities currently have a "middle of the bull market" feel about them; not yet in bubble territory, nor likely to crash anytime soon. Economic growth rates are improving, albeit slowly. There is no excessive volatility.

Stock valuations are not comparatively excessive, and there seems to be plenty of money for investment, with the European Central Bank adding more over the next year.

It may be that this time it is different, that we will break the seven-year itch and equities will rally until valuations are too stretched and the debt has to be called back in. It does not look like we are there yet.

But bull markets die hard. And what will cause the crash? Possibly interest rate rises? More likely a surge in the oil price? Most likely there is something on the horizon that our blinkered behavioural finance biases do not yet regard as being a problem.

This is the famous "unknown unknown". It does not matter what; the markets will find an excuse. What we do know is that the current Chinese stock market, having fallen for six years, is likely to be a defensive place to invest – what has not gone up is unlikely to go down much more.

It is the last major world market not to significantly recover since the global financial crisis. So a major indicator for the top of the equity cycle could well be our own market.

If it seeks to quickly recover the lost ground that could be a major negative indicator for global equity.

Enjoy investing now. For then we will be playing another bias in behavioural finance theory; the "last fool".

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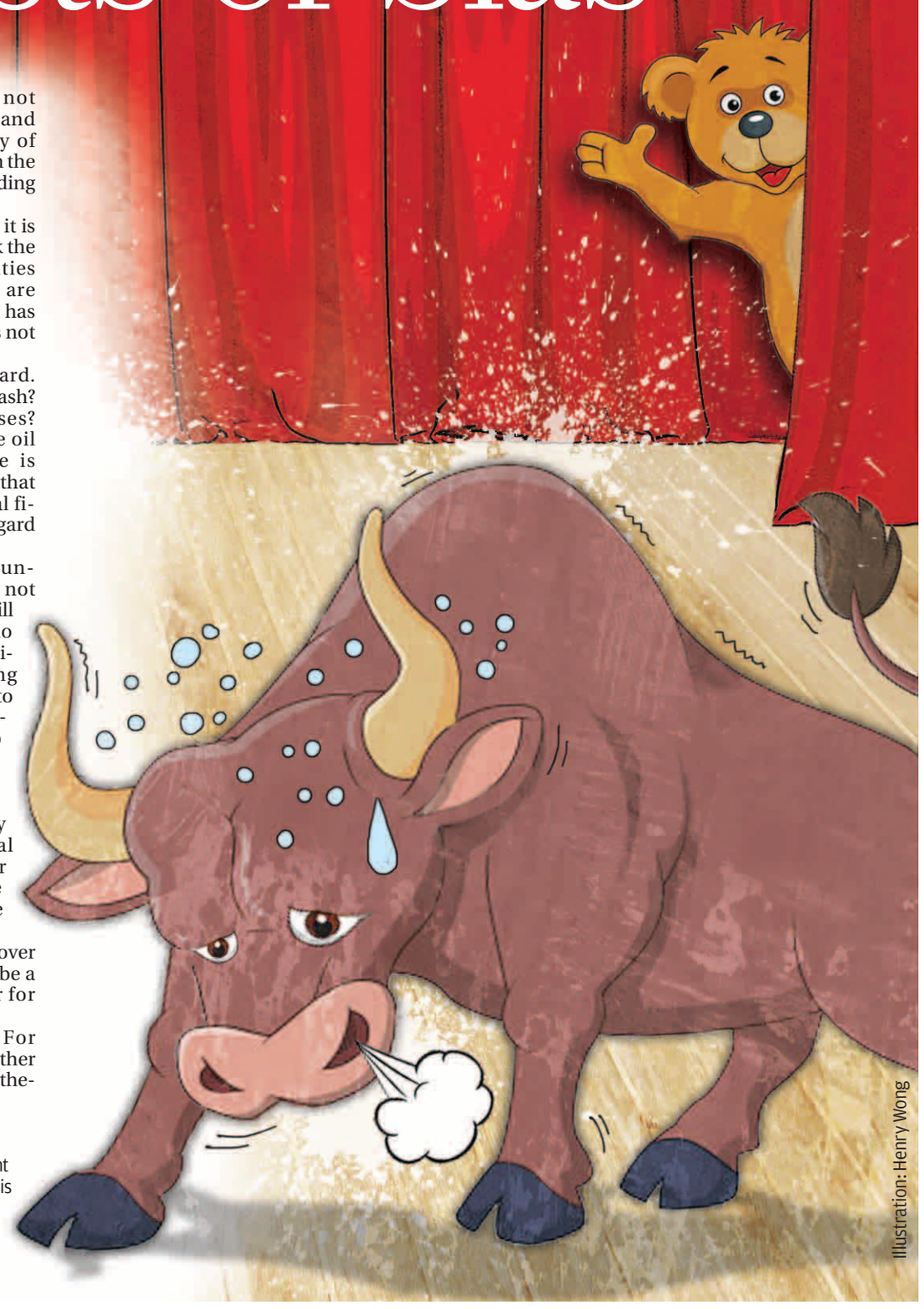

Illustration: Henry Wong