Dealing with Difficult Times

This discussion was written in September 2001. The lessons are of a general nature and apply to all difficult times.

Historical Perspective

This week has seen the terrorist attack on New York and Washington. My thoughts go out to all those who have lost loved ones and otherwise had their lives and plans so cruelly disrupted. It is also my hope that US leaders will not succumb to the temptation to lash out blindly, but that cooler heads will see that this is a time for learning lessons and that exacting vengeance is not the way of true Christians or Muslims. On the freeway there are signs that say "Wrong Way – Go Back". It is not too late for true leaders to try another way. The way of compassion, tolerance and mutual respect that leads to peace.

In difficult times it is always important to keep an historical perspective and this is never more important than in investment and trading. The US is a great country and economically it will recover from this disaster, as it did from the San Francisco earthquake, the sinking of the Lusitania and the attack on Pearl Harbour. In our frenetic fascination with trading, we forget that financial markets exist to mobilise capital. Business does not exist to exploit us, as the lunatic fringe would have us believe. Rather, business is about building enterprises that meet our needs. The US needs first to bury its dead, but then will come the rebuilding. This will be done by businesses. Shareholders are the owners of those enterprises. Investors should be looking for opportunities to participate in this process by channelling their savings where there is opportunity. Financial reward for investors flows from successfully meeting those opportunities.

Australia, too, has recently been challenged on some important issues, the refugee crisis being the most important moral dilemma. Before we rush to condemn the actions of others and to sit in moral judgement on them, we should examine our own country's lack of humanity and compassion for people who are less fortunate than us, have a different faith and come from a different race. The debate I have been hearing is about the great sickness in our society – the focus on our ***right*** to do this or do that. What I long to hear from our leaders is the declaration and acceptance that we also have ***responsibilities*** to others.

Returning to the markets, it has been a difficult time for technical analysts, because with US stock markets closed, there is no price action to analyse. However, what is clear is that the other two major markets that I watch behaved in a quite normal manner, despite all the sensational news reporting. In order to maintain perspective, it is best to stay clear of the media and think for ourselves. The media is all about exploiting our emotions. Emotional decisions in the markets are very rarely good ones.

It seems to me that the London and Tokyo markets were already falling in a bear market move before the news from the US hit us on Wednesday. The falls that day were magnified a bit by the circumstances, but not really unusual to my eye. Even in Australia, a strong downtrend was already under way, which I had been alerting my *Shares* magazine and *Shares Weekly* column readers about.

In deciding what to do as the US markets reopen, the popular media will be a very poor guide. We need to think through the hysteria to the reality. We need to react rationally to the evidence on each chart and shut out the emotional noise from the media. The world is not about to end. We have to assume that Americans will rebuild their lives as happens all over the world all the time in the face of even greater catastrophes. Bad things happen in bear markets. They shape the process, but they are inherently part of it. Keep a focus on the big picture. Set strategy on the big view. After that, the tactical problems are quite straightforward.

Markets and the Information Age

Following on from the above discussion of the need for historical perspective, I would share with you an insight about the Internet boom. I picked it up in *The Australian Financial Review* lift out *The Fin* 8-9 September 2001 pages 1 and 3. The article contained a brief description of the way in which we are influenced, not by information, so much as by the ***feelings*** or emotional content. This idea ties in with a book I am reading that touches on the extent to which most people have difficulty reading and understanding financial information.

So, what tends to happen is that many people do not bother with the information content and instead take the easy and comfortable way out of just absorbing the ***feelings*** coming out of the information. This leads to markets that are disconnected from the real economy and driven by rumour and emotion. The interesting idea conveyed in *The Fin* article is that *Once a critical threshold ….. has been passed, the safety net of established models is abandoned and people start to build an alternative domain, divorced from reality.* I talk about this in my seminars – about the way every one of these technology booms has thrown up new paradigm theories – always based on the premise that it is somehow different this time.

The way to make profits in the markets is to realise that the established models have worked over and over again. The *new era* ideas that have accompanied each boom have turned out to be false prophesies over and over again. So, how do we make money in the markets? Is it by hoping it will be different this time, when it has never been before? Or is it by assuming that the established models, rooted in long observation of the playing out of the economic cycle, will again be our best guide?

So, *The Fin* article goes on: *This* [new] *model becomes dominant and grows by its own resources until the moment when its detachment from reality becomes too obvious. Then we see a brisk return to the models previously rejected.* Have we not seen this? Did the unreality of the Internet boom not explode and was it not followed by a flight to safe havens in the real economy?

Now we have been struck by a disaster in the US, albeit blown out of all proportion by the media. This process was presciently dealt with in *The Fin* article, when it went on that *The initial enchantment has given away to disenchantment. But both follow the same logic of being slightly at odds with reality. The* ***anti*** *position is as unreal as the initial over-enthusiasm*.

The key to dealing with the bear market is to maintain balance. The great temptation is to see each disaster, whether it is terrorism or a commercial failure like One-Tel or HIH, as the start of the end of the world. It is a time to turn off the TV, the radio and the Internet and go down to your local library or bookshop and get some history books. A truly radical thought that. It does not have the glamour of day trading, but it might set you up to survive the bear market and to profit from the inevitable recovery.

The Futility of Forecasting

When they first come to the financial markets, most people seem to have the belief that the experts have more knowledge than ordinary people, which enables them to correctly forecast the future. Now, the truth is that they are half right, but they are also half wrong.

They are right that the experts have more knowledge than ordinary people. This is true in all professions. Unless someone has studied a subject extensively as a hobby, the trained expert person will always have more knowledge.

Where they are half wrong, is that this knowledge has nothing to do with forecasting. There are lots of people out there who try to forecast the financial markets. Most of them fail to get it right. Over the years I have seen lots of surveys in which a range of experts have guessed where they think a financial market will be on a future date. The interesting thing is how often they are simply assuming little change, or projecting a current trend into the future. Quite often, the actual result is outside the range of all the expert forecasts.

There is another trap here too. Experts and historians tend to be very good a explaining the past, after all there is ample evidence. They then use this ability to explain the past as a reason why they are better able to predict the future than ordinary mortals. However, the ability to assess the evidence and explain the past is quite different to being able to foretell the future.

Now, it is well known that weather forecasters are second only to economists in how bad they are at forecasting. In fact, it has been shown that if you consistently forecast that tomorrow's weather will be like today, you will be right far more often than the expert forecasters. The question is: Do you see the logical problem here?

The problem is that weather patterns tend to persist for several days or more before they change, which is why the method works. However, what we really want to know of a weather forecast is when the pattern is going to change. If you are a farmer and your lambs are out in the field in benign sunny days, what you want the forecaster to tell you is when there will be a frost that might kill the lambs, so you can try to protect them.

So, with forecasting the weather, or the financial markets, it is the changes that are important, not the consistent conditions. However, the real rub is that there are only a few people who are really good at making predictions:

1. Those who make so many predictions, that sooner or later one will be right. Then they remind us of that prediction and don't ever again mention the wrong guesses. I have seen several market gurus who have established reputations like this. There is also the apocryphal advice by the old forecaster to the new guy: *Forecast often and destroy all back issues of the newsletter*.
2. Those who make predictions in such vague terms that almost anything could be read into them with hindsight. The best example ever is probably Nostradamus. However, he has many imitators in financial markets and elsewhere that people are parted from their money.

3. Liars and charlatans, posing as gurus, who are trying to sell you something.

This is fairly depressing for most beginners. However, it need not be. Once a person gets past this whole wrong conception about how money is made in financial markets, they can move on to learn the trade.

The way I teach is that we must first find a way in which the markets are going to provide us with an opportunity to make money. We design a strategy around this "edge" as it is called. This strategy is about controlling the risks that must be assumed in the markets if we are to make profits.

Then we can observe the current condition of the markets: we assess whether the price of prospective investments is attractive relative to the value of the business in which we seek to invest. We can also seek to understand what buyers and sellers are doing and what the relative level of risk is. We can then assess whether the investment opportunities in the market match the opportunities we are looking for. If they are there, we put our strategy into action. If they are not there, we leave our money elsewhere.

After that it is all a matter of tactical management of our investments. We must have clear rules for how we are going to manage our positions. We compare our models to reality. If they are on track, we hold. If reality diverges from the model, we get out of the investment.

Intellectually, none of this is difficult and I can teach you the basics in a couple of days. The problem is us – what goes on in our heads. This requires experience, which cannot be taught, only lived through. Once we start into learning in that area, we are on the home straight. At the end of the race, most people are still back behind the starting line wondering what happened to their money. I can get you to the starting line with a realistic chance of competing. Then the rest is up to you.

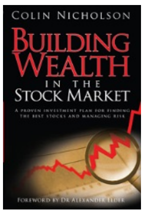
To read more of my work

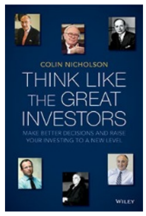
Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:





BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website

