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Simple Thoughts on the Current Global Financial Climate

A few months ago while jogging with a friend, I commented that of my two degrees from the University of Toronto, my Bachelor of Science in mathematics was often more important to me in the investment industry than my Master of Business Administration in finance. Both degrees are important. The mathematics, however, enables some depth perception I would have never enjoyed otherwise.

Here are a few thoughts and beliefs, somewhat from a mathematical perspective, that may put a little light on the world today.

1. The steady state of socio-economic systems such as the stock market and the economy is not straight line, but harmonic motion (like the swing of a pendulum). If all other factors were to remain unchanged, the stock market would still have its ups and downs. The economy would still see growth and contraction phases. In short, bear markets and recessions are as normal as air. There is little point in getting excited. Bear markets and recessions have happened repeatedly in the past and will happen repeatedly in the future.

2. Since the early 1980's, interesting work has been done on the mathematical application to the stock market of chaos theory and fractals. A lengthy discussion of chaos and fractals is beyond the scope of this article. Let it suffice that some appreciation of chaos theory and fractals would lead us to greater comfort with the jagged patterns of a stock market index over time. Call it nature, much like the weather that brings us both nice days and stormy days. By appreciating chaos theory and fractals, we understand the big picture better and expect periods of negative returns. We also understand that everything will work out okay.

3. Since 1970, the Toronto Stock Market Total Return (i.e., dividends reinvested) has multiplied 38 times over. Simply stated, from early 1970 to the end of September 2008, you made 38 times your money in 38 years – not a bad investment! However, during that 38 years there were six periods when you would have seen your investments decline by a third. Typically, the declines lasted an average of ten months. Very simply, over long periods of time, the market goes up more than it goes down but we can expect it to go down from time to time.

4. Market timing does not work. For it to work, both the sell and the buy have to be timed right. That simply never happens consistently. The market is too chaotic (and fickle!). The best plan to optimize return is stay invested - always. Because markets are chaotic, market timers are shown by a number of studies to have generally poor long-term investment performance.

The four most costly words to investors are "This time is different". Moving out of equity during periods of pessimism causes investors to effectively lose again when markets rebound.

5. A significant portion of the selling in the stock market that we have seen in the last few months is a result of:
a) Institutional selling (e.g., hedge funds selling to meet redemptions)
b) Tax loss selling at the end of 2008
c) Margin call selling (brokers are forced to sell out clients who are over leveraged)

Selling for these purposes does not last forever, but does cause short-term downward pressure on stock prices like we have seen recently.

6. There is about $3.5 Trillion in the U.S. sitting in money market funds earning virtually nothing. That amount is about 45% of the value of the S&P 500. When the stock market starts to show strength, some of that $3.5 Trillion will flow back into the stock market and add fuel to the next bull rally.

7. There is new management at the White House effective January 20, 2009. I expect that a new president will create a better investment mood and climate going forward. (The last eight years in the White House have not been impressive.)

It is also important to remember that the stock market is a leading indicator and starts to go up well before a recession is over. It is not unusual to se a stock market go up 25 percent or more before a recession is officially over. Never wait for "good" economic new before investing, because too much investment profit is missed.

8. The sub-prime problems in the United States were an accident waiting to happen. Sadly, the bailout costs could have been used to install universal health care in the U.S., solve world hunger, *and* buy all of the sub-prime securities at book value. While capitalism can work well, we have experienced one of the worst cases of irresponsibility, short-sightedness, and greed of U.S. financial institutions. And this is not the first time major financial institutions have behaved badly. In the early 1980's we experienced the Latin American debt crisis. The bailout was about $500 billion (and life went on). About twenty years ago, the United States suffered the S&L "crisis". The bailout was about $400 billion (and life went on). We shall get through the current silliness and life will go on.

9. The information flow from the stock market is excellent. We can get valuations of our portfolios instantly. Imagine how people might react if every day they were able to open up the newspaper and see the daily closing values of their houses. I expect many would experience high anxiety if they saw their house fluctuating a few thousand dollars a day. In housing, ignorance on day-to-day valuation is bliss. Perhaps we should apply the same attitude to our stock market holdings and not worry so much about short-term fluctuations.

10. Feed-back loops profoundly affect markets and the economy. For example, if people expect a recession, they spend less. The result is recession. That situation is a negative feedback loop. A hot housing market pulls more speculators and more buying into the housing market. The housing market gets hotter. That situation is a positive feedback loop. Invariably, feedback loops run out of steam and situations return to a more normal state. We have recently experienced much negative feedback in both the stock market and the economy. Will the stock market and the economy get stronger? History tells us to expect positive outcome. And because of feedback loops, be very cautious of hot trends. Bubbles burst – always.

In conclusion, I am reminded of a discussion with a friend during the recession in the early 1990's. I asked him how the recession was affecting his business. He replied "Recession? Oh, that. We had a meeting and decided not to participate." Indeed, most of us are little affected by the economy. We continue to work and pay our bills. If anything we are currently enjoying better prices at the fuel pump and cheaper vacation deals when we travel. And for those of us who invest, we are seeing excellent buying opportunities in equities that we probably will never see again. I compare it to a huge sale at the outlet mall, which in many ways is something to feel good about. After almost thirty-four years in the financial sector, I have become numb to the daily noise from the business media. It may be interesting, but it is noise and worrying is a waste of emotional energy.