Strategy Thoughts

March 2023

The Cycle in Investor Attitudes to Risk

Introduction

I concluded last month's Strategy Thoughts with; "Investors should remain sceptical of this current bounce, and myriad of comforting economic forecasts. There will be another great long term buying opportunity, but we weren't there last October and are certainly not there now."

Since then, despite markets meandering sideways to down, attitudes, expectations and hope have become even more inflated. This edition of Strategy Thoughts reviews some of the evidence for this increase in risk appetite and examines what history indicates it may mean. It will also question the trend of investors shifting their attention away from the US market, that has certainly out performed globally since the GFC, in favour of international markets, and whether international markets may offer a reasonable alternative if a major bear market lies ahead for the US.

But first I will review what 'cycles in investor attitudes to risk', a phrase popularised by legendary investor Howard Marks, may be telling us, and also what risk actually is.

Cycles in investor attitudes to risk, and what is risk?

I recently listened to The Oaktree Capital Management podcast 'Rewind – Ditto' with Howard Marks and Brookfield CEO Bruce Flatt and this prompted me to reread Howard Marks' memo Ditto from January 2013. Amongst the many brilliant insights that the memo contained the one that resonated most with me was;

> "Over the years. I have become more convinced that fluctuations in investor attitudes to risk contribute more to major market movements than anything else. I don't expect this ever to change."

These three sentences neatly summarise the primary idea behind my 2016 book "Investing – The Expectations Game", particularly chapter four that was titled "What Does Drive Markets, 'remember the stock market is a manic depressive' (Warren Buffett)". Early in that chapter I included a schematic somewhat similar to what is shown below.

This schematic depicts in a very simple form the progression of investors attitudes to risk, or their expectations, as a bull market unfolds, peaks then rolls over into a bear market before the cycle begins again. What is interesting is that as the bull market unfolds investor attitudes become increasingly risk tolerant, in fact it is because investors become more tolerant of risk that the market rises. Investors become increasingly aggressive, and confident, the more the markets rise and start extrapolating ever higher returns. As this happens investors may say things such as 'what risk, in the long term markets always rise, and anyway as risk and return are related the more risk I take the more returns I will receive'. Unfortunately, at some point investor expectations become too elevated, and the number of potential new investors dries up. At that time, when investor risk appetite, and the market, are at their peaks, the bull market ends and a new bear market begins. Initially investors dismiss that first down draught as just a correction, and a dip that should be bought, comforting themselves by believing that they were in the market for the long term. As the bear market continues those comforting thoughts evaporate and turn into despair and panic. Once that point is reached, and investor attitudes to risk are at their lowest, investors give up and vow never to get sucked back into that market again, and so a new bull market can begin. This cycle has been seen throughout history and across asset classes, and as long as humans and all their behavioural foibles are involved in markets, as Howard Marks pointed out, it is never likely to change.

What this all highlights is what risk is. Warren Buffett famously pointed out in his investment rules what risk was. His first rule is 'never lose money' and his second rule is 'never forget rule one'. Losing money is the primary risk that investors face. Famed investor Bruce Berkowitz summed this up well;

> "I *define risk as the chance of* **permanent capital loss** adjusted for inflation. Volatility, I believe to be just price changes based on market perceptions of risk. Risk does not equal volatility." Bruce Berkowitz

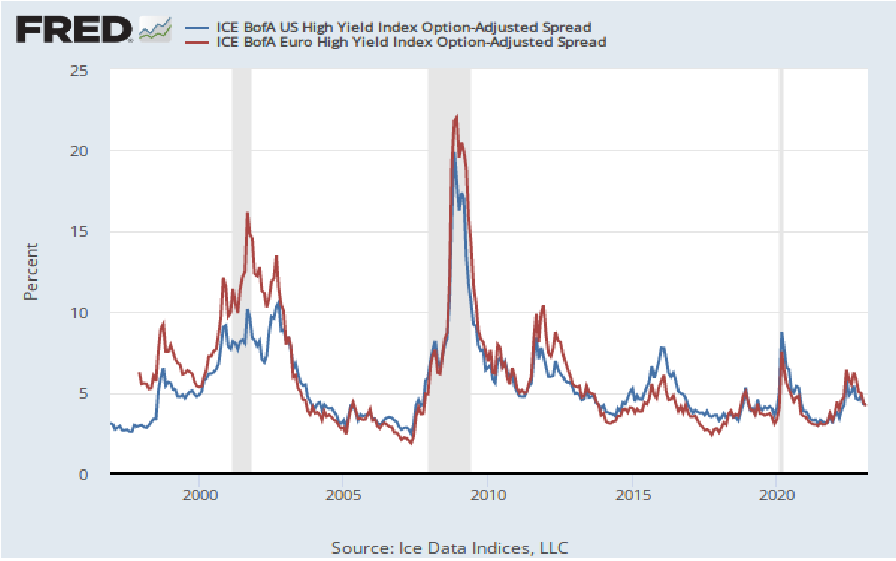
It is frequently stated that risk and volatility are one and the same in investing, this maybe somewhat true for some institutional fund managers who only care about their performance compared to their competitors, but for most investors their absolute, not relative return, is what matters and their biggest risk is the permanent loss of capital.

Getting back to the cycle of investor attitudes to risk, what becomes clear is that ironically investors face their greatest risk of loss when their appetite for risk is at its peak, equally the greatest opportunities are found when risk appetites are at their lowest.

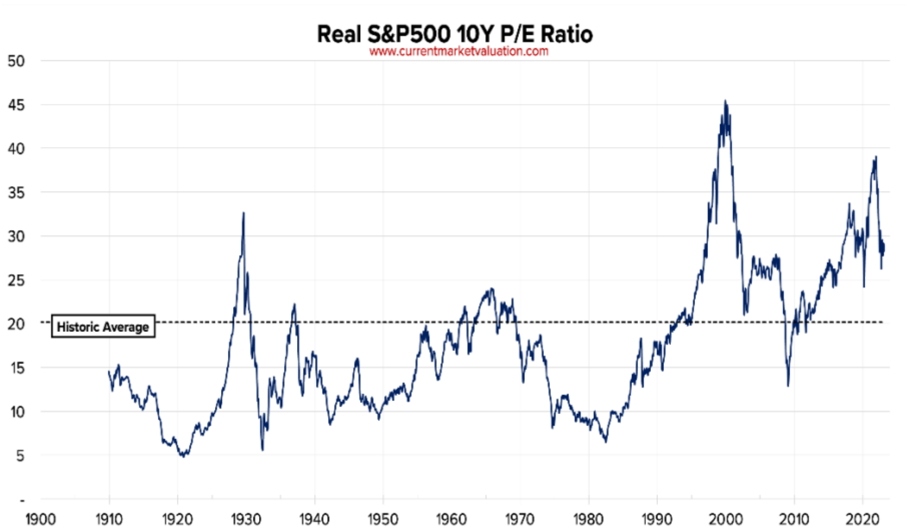
Where anything lies on the cycle in investor attitudes to risk, and so its level of risk, is therefore determined by its price and where it has come from. Not by how volatile that asset may be nor by the quality of that asset. Marks points out at length in 'Ditto' that low quality assets bought at historically cheap levels can be highly rewarding, just as high quality assets bought at ridiculously extreme prices. His example here was the so called 'nifty fifty stocks' of the 60s and 70s that were supposedly one decision stocks, due to their high quality, and could be held forever. They achieved incredible price earnings multiples at their peaks before falling by up to 90% in value. Despite their supposed fundamental high quality at ridiculous prices they were very high risk.

The challenge for investors is identifying exactly where markets are in relation to their cycles of attitude to risk. There is no absolute measure of investor expectations, and even if there were there is no law that states that once a particular level is reached things will reverse, irrational markets can always become more irrational. Nonetheless, it is useful to look at some indicators of investor attitudes and compare them to historical extremes.

The chart below shows the spread between high yield (junk) bonds and high quality bonds. When investor appetites for risk are high then these spreads are low. They were low in the late nineties, prior to the dotcom bubble bursting, they were low in 2007 prior to the GFC and they were historically low eighteen months ago as many markets were recording their highs. Perhaps more importantly, the recent runup in spreads is far from that which has been seen at great buying opportunities of the past.



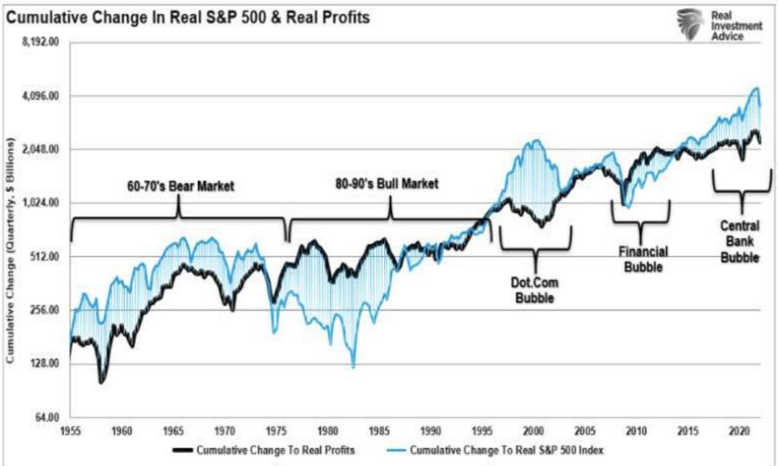
The next chart takes a long term view of appetites for risk based on the price investors are paying for the earnings companies are making. Historically stock markets have been far more volatile than aggregate corporate earnings, this is why price earnings multiples expand and contract the way they do. When investors are prepared to pay enormous multiples for earnings than risk appetites are obviously high. This was seen in the late twenties, the sixties (when the nifty fifty dominated), and in a dramatic style in 2000, at the peak of the dotcom boom.



At the last stock market peak, investor appetites for risk appear to have been as high as they have ever been, apart from 2000, just before the NASDAQ fell by 80%.

The recent slight set back has been just that, slight. Even 2009 doesn't register on this measure as an historic trough in investor attitudes. For that one has to go back to 1982, 1932 and 1920.

This same measure can be looked at in a slightly different way in the chart from Real Investment advice. It shows the cumulative change in the real (inflation adjusted) S&P500 and real profits. The blue shading indicates deviations in the market price either above or below earnings. That the market was expensive, and so appetites for risk high, in the sixties, 2000 and recently is obvious. As is the extraordinary long term buying opportunity that was seen in 1982.



There are many other pictures that would tell a similar story.

In summary, the primary source of risk for an investor is the price they pay, NOT the quality of the asset they buy and currently it would be very difficult to argue that prevailing prices are still indicative of anything other than a high appetite for risk.

Shorter term attitude or expectational indicators

Identifying extremes in expectations, or risk appetite is, as I mentioned earlier, very difficult, particularly at peaks in markets. Very long term readers of Strategy Thoughts and its predecessor publications would know that the lows of 2002/3, after one of the largest bubbles in history had burst, and the most recent important low in March 2009, were identified as attractive long term buying opportunities in a very timely fashion. For some reason the depths of despair appear to be more easily pinpointed than the peaks of euphoria. Those same long term readers would also know that I have highlighted the need for extreme caution way too early in each of the last three bull markets. That being said there is an old Wall Street adage that goes something like 'bulls make money, bears make money, but pigs get slaughtered'. It doesn't pay to be greedy in investing and if one can get in near important long term lows, having avoided the preceding carnage, it doesn't matter if the last of any upside is not taken. The important thing is to maintain discipline and not to fall into the trap that it is said Sir Isaac Newton did during the South Sea Bubble. Newton had made a comfortable profit in the early stages of the bubble in South Sea stock and decided to take his profit, but then after his sale the stock continued to soar. The more it rose the more upset Newton was that he had 'lost' so much by selling, eventually he could stand it no longer and he bought back in, only to see the market almost immediately reverse along with his fortune. He supposedly lamented that he could "calculate the motions of the heavenly bodies, but not the madness of people."

Whilst identifying extremes at market peaks is difficult it is still worthwhile if it prevents an investor capitulating like Newton and jumping back in near the peak.

History has shown that by the time retail investors are charging into the market it is likely near the end of that particular move. This was seen through 2021 with the likes of GameStop and other so called meme stocks that were touted through various online chat groups. That resulted in a surge in retail participation, albeit highly speculative, just as the market peak was approaching. Recently it seems the same theme is occurring;

The Meme Stock Frenzy Is Back. A Brokerage Chairman Says They're 'Horrendous.' Barron's Jan 20

Meme-stock 2.0: Wall Street's retail trading boom is back FT Feb 17

Two years on from the frenzy, small investors grab largest-ever share of US market activity

With the result that retail trading is once again setting records.

Retail Trading Just Hit An All-Time High. Here's What Stocks Are The Most Popular Forbes Feb 3

Retail investors have piled into US markets this year

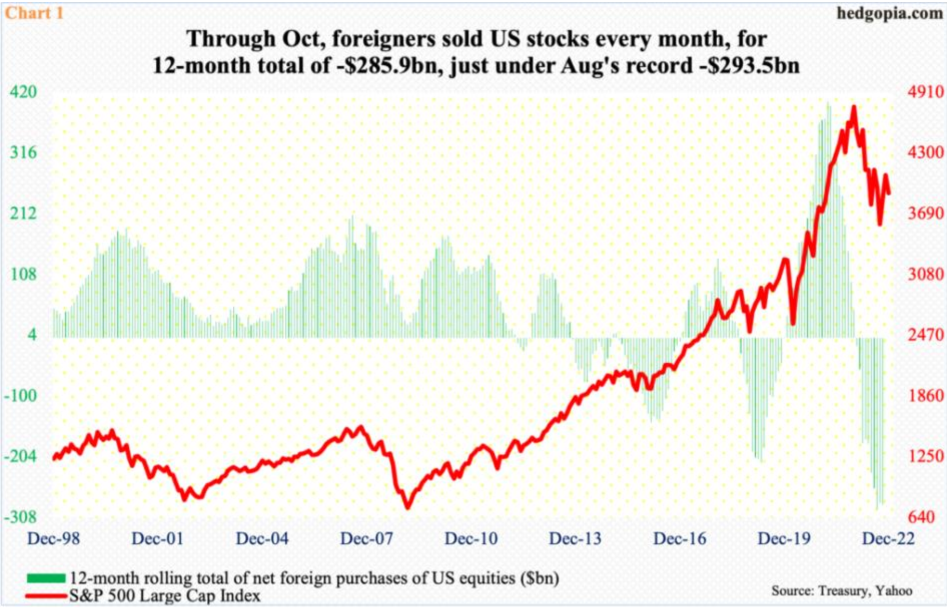
Daily net inflow by individuals ($mn, 21-day moving average)

Source: Vanda Research
© FT

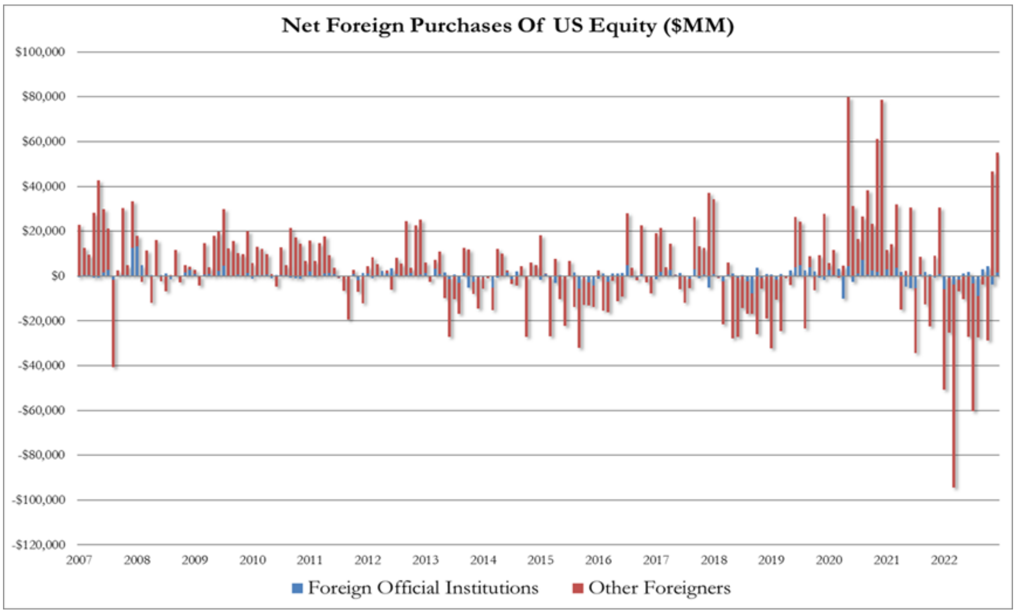
On the 21st February Zerohedge reported;

"in the last month, retail investors poured an average of $1.51bn/day into the US markets, the highest amount ever recorded."

It is also said that by the time foreigners start investing in a market in a big way then that bull market will be approaching its end.

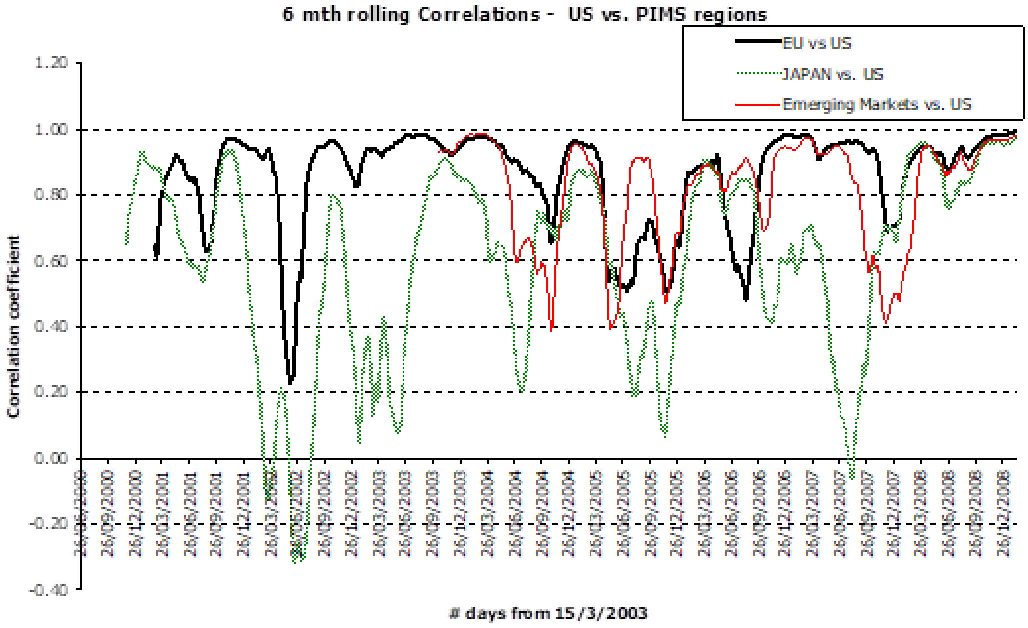


The twenty five year chart above shows that the best time to be buying the US market has generally been when foreign buyers are least interested. There was minimal foreign buying at the bear market lows in 2002/3 or 2009, but there were big spikes in interest towards the end of lengthy bull markets, particularly in 2000, 2007 and most recently in 2021. The updated chart below shows that the most recent rally has also attracted substantial foreign interest with activity similar to that seen in 2021



There's always a bull market somewhere

That there is always a bull market somewhere is another old investment adage that does have a kernel of truth in it, most of the time. Unfortunately, it does not always hold true. One only has to think back to depths of the GFC when there was nowhere to hide except cash. In the March 2009 edition of Strategy Thoughts I included the following chart.



It compared the rolling six month correlations across the four major equity regions that we broke the world into at that time, Europe, the US, Japan and the Emerging Markets. What it showed was a frightening convergence in the correlations as the bear market progressed from late 2007 and through 2008, to the point that in the early months of 2009 all correlations, some of which over preceding years had been zero or even negative, were almost exactly one. There had been nowhere to hide.

If a recession in the US is all but inevitable, and prospective returns from US stock markets is destined to be somewhere between poor and miserable then should investors be looking elsewhere? This on one level is a sensible question, and one that is being increasingly asked, with recommendations to look internationally abounding.

> **This asset class is outperforming U.S. stocks in 2023, and you may be missing out**
> CNBC Jan 19

> US investors dump domestic equity ETFs for overseas funds FT Feb 3

That article highlighted one of the rationalisations for this switch;

> "We have seen signs of relative strength in the economic data coming out of Europe,"

If only it were that simple!

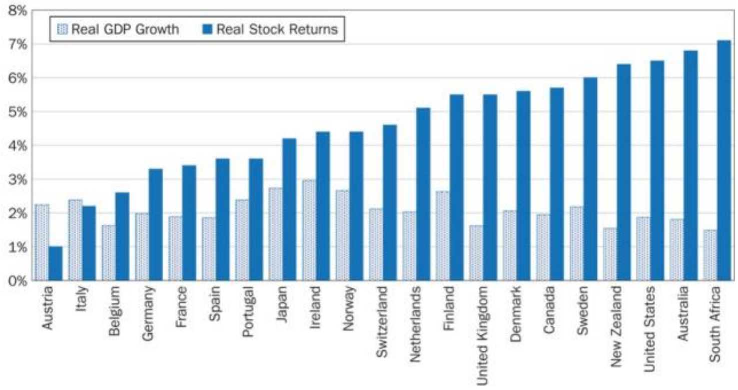
A May 2010 research bulletin from MSCI Barra, which I have referred to in the past, asked the question;

> Is There a Link Between GDP Growth and Equity Returns?

The bulletin stated;

> Several studies (Dimson et al. [2002], Ritter [2005]) have examined whether countries with higher long-run real GDP growth also had higher long-run real stock market return. The surprising result was contrary to expectations -- the correlation between stock returns and economic growth across countries can be negative! Our own analysis confirms this empirical finding.

Later research by Jason Hsu, Jay Ritter, Phillip Wool and Yanxiang Zhao confirmed this finding, in fact the chart below hints that actually the reverse may be true, ie. the lower a region or country's real GDP is, the better the return.

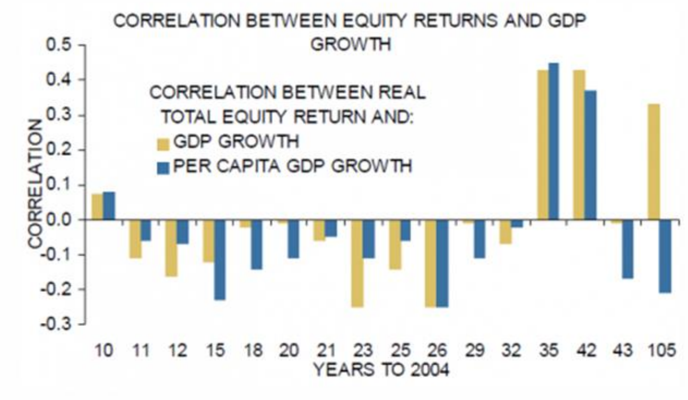


Real GDP Growth and Stock Returns in 21 Developed Markets, 1900–2019
NOTES: This exhibit plots geometric average annual per capita GDP growth and stock returns from 1900 to 2019 for 21 developed markets. For 1900–2011, data on real per capita GDP come from the Maddison Project's *cgdppc* series and for 2012–2019, from the International Monetary Fund (IMF) and the Population Reference Bureau. Stock returns are from **Dimson, Marsh, and Staunton (2020)**, expressed in local currency terms. The cross-sectional correlation of stock return and per capita GDP growth is statistically insignificant, at −0.31 (*p*-value = 0.17).

Despite this the majority of investors build their case for investing wherever they do on economic reasoning. It may provide some comfort for why they may pick one region over another, but history has repeatedly shown that comfort and success in investing rarely go hand in hand. Even in a single market economic forecasting is actually of little help in forecasting stock market returns. One example of this I included in 'Investing – The Expectations Game';

> A study of returns in the Australian stock market over fifty years from 1951 revealed further support for the 'sluggish is best' strategy. In years when Australian real GDP exceeded its long term average the average return from the Australian market was 5.2%. On the other hand, when growth was below the long term average the returns from the stock market almost tripled to 13.2%!

Exhibit 2
GDP and Equities: No Correlation

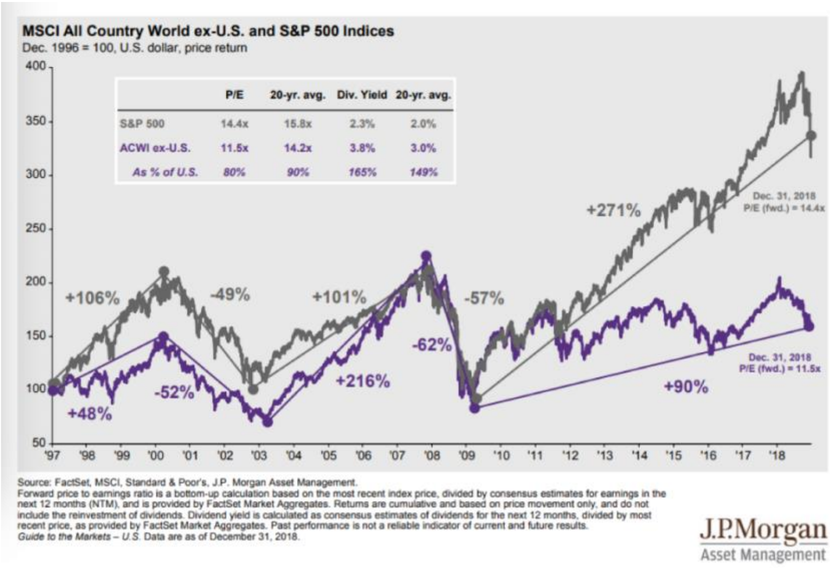


Source: Triumph of the Optimists: 101 Years of Global Investment Returns, Elroy Dimpson, Paul Marsh & Mike Staunton, Morgan Stanley Research

As the chart above shows the correlation between stock market returns and GDP is more often negative than positive.

Getting back to the more immediate question of whether US investors should be looking overseas, and whether the damaging effects of a US bear market can be avoided in other international markets, it is worthwhile looking at how such a strategy would have worked over the last two major US bear markets.

The chart below shows the S&P500 over the last twenty five years and the MSCI all country world index excluding the US.



The bear markets after the dotcom bubble burst and associated with the GFC are both very obvious, but what should be equally obvious is that through both of those enormous bear markets of minus 49% and minus 57% international markets fared even WORSE. Given the massive underperformance of international markets since 2009 it is possible that they may not fall as severely as the US market in any forthcoming bear market, but they are unlikely to buck the trend entirely.

Conclusions

Understanding what drives markets is essential to any investor, it is easy to take comfort in economic analysis or earnings estimates but ultimately the primary driver of investment markets is the level of investor expectations. When they are too high the risk of disappointment and a bull market turning into a bear market is high. Similarly, when they are too bleak it is almost certain that what ever happens it may not be as bad as had been feared and that positive surprise can mark the end of a bear market and the beginning of a bull market. Or as Howard Marks wrote fluctuations in the level of investor attitudes to risk are the primary driver of market movement.

For sometime investor attitudes towards risk have been very relaxed, that may have started to change at the margin but there is a very long way to go before a long term buying opportunity is at hand. In the meantime preservation of capital makes eminent sense and if correlations once again go to one there may well not 'always be a bull market somewhere'.

Kevin Armstrong

3rd March 2023

The Expectations Game

If any readers do not have a copy and would like greater insight into what really drives markets, please contact me directly at; kevin@strategythoughts.com