My background

- PC industry 1983-2002 in technical and management roles
- AIA member since 2004
- Self-directed personal and SMSF investor since 2005
Good, bad and the ugly

Early setbacks:
• Starting with a trading mindset – quick profits, only using technical analysis
• Looking for “experts” and gurus (almost always with their own agenda)
• Late 2003 – Mid 2005; unsatisfying flirtations with 3 full service brokers
• Learning to recognise mediocre financial advice (it took a little while)

Objectives:
• Educate myself to become an independent investor
• Read widely on investment matters – investors must learn many skills
The 4 stages of Competence

- **Unconscious incompetence**
  You are unaware of the skill and your lack of proficiency

- **Unconscious competence**
  Performing the skill becomes automatic

- **Conscious incompetence**
  You are aware of the skill but are not yet proficient

- **Conscious competence**
  You are able to use the skill, but only with effort
Steps on the education journey

• I joined ATAA in late 2004 – President was Colin Nicholson
• Colin advocated formal, structured study and said it takes at least 10 years to become a skilled investor (the usual 10,000 hours to master anything)
• I was starting a new career as a full-time private investor, managing our life savings and preparing for retirement. I needed to take it seriously and treat it as a business
• I looked for a professional-level course to get broad, basic financial knowledge

My guiding equation: Skill = Knowledge + Experience

I invested a lot of time, sweat and $:
• Dip. Technical Analysis at SIA (2005), a course largely developed by Colin
• Master of Applied Finance (2010-2011)

Knowledge alone is not enough – skill comes from learning how to apply knowledge
• It requires a lot of time and practice, learning from your mistakes and successes
• I’ve used Colin’s 1st book (and about 300 others), attended countless seminars and conferences to help develop our investment strategy (an ongoing project)
News, noise and chasing rainbows

Be sceptical:

• The “market” consists of millions of participants worldwide with widely differing objectives, investment timeframes and countless different methods
• Markets are impossible to predict, especially short-term (easier long-term) because of the huge number of interacting factors, which change constantly
• We get a constant barrage of “news”, opinions, statistics and expectations
• The effect of today’s “news” may be different (or have no effect) next week
• Don’t confuse correlation with causation – the media does this every day
• Everyone thinks they can “beat the market”, but very few do so consistently
  – We fool ourselves by thinking we’re all “above average”
  – 90% of professional fund managers don’t beat the market after fees
  – Even Warren Buffett struggles to beat the market consistently from year to year because the market is itself inconsistent - see http://www.berkshirehathaway.com/letters/2013ltr.pdf
• The Sunday paper dartboard and astrologer frequently outperform “experts”

Give up the Holy Grail quest:

• Avoid market “gurus” selling expensive courses, “mentoring” programs etc
• Beware of arcane methods, “secrets” and “hidden cycles” within markets
Investor psychology

• Fight your natural emotional responses – they are mostly wrong and will negatively impact your returns and your mental wellbeing

• Don’t get spooked by the financial mass media
  – Their job is to fill empty space, not your pockets (TV hosts tell guests to “just keep talking”)
  – It’s largely noise and babble, often by those with something to sell you
  – The conflicting opinions and “advice” will drive you crazy with fear and indecision

• “I skate to where the puck is going, not where it has been” – Wayne Gretzky
  – The Canadian ice hockey legend understood he can affect the future, not change the past
  – Successful people anticipate events. They then plan, rehearse and practice their responses
  – “Gut feel” is only for very experienced investors – beginners should pay no attention to them
  – Most people lack a comprehensive and robust financial plan; they just hope for the best
  – A “Steven Bradbury” result is an even less probable outcome in investing than in sport

• The only solution is to prepare yourself:
  – Have a comprehensive, robust investment plan designed for your needs
  – Build your confidence in it; put it into practice, test it with real money and refine it over time
  – Stay focused on your plan’s overall strategy and objectives
  – A good plan keeps you sane and filter out the daily noise. Learn to analyse, then act
What moves Mr Market?

Mr Market is bipolar; a manic depressive
• His emotions swing wildly between euphoria and panic, depending on his feelings about the near future
• He thinks the latest news is the most important news he’s ever heard and he must react immediately
• Whatever has just happened he thinks will continue to happen for the foreseeable future (recency bias)
• He often overreacts to news, then changes his mind about the “newness” of the news or its importance
• He blindly chases the herd until it turns another way – he is never contrarian nor thinks independently

At any given time, the stock market is NOT well correlated to the economy
• Markets are forward looking, trying to “price in” the future or using industry jargon, “discount” it.
• The market tends to look ahead about 6–9 months; a period able to be forecast with some reliability

If you just saw it on the TV news, it’s old news
• Professionals probably factored it into their expectations and valuations weeks ago (already priced in)
• Equities are heavily affected by the much larger but less visible bond and currency markets
• If front page has doom and gloom or 1ˢᵗ news item on TV, be prepared to buy; if euphoria, look to sell

Why was XYZ stock “down today after record profits” or “up after a big loss”?  
• It was better or worse than professionals’ forecasts or expectations – a positive or negative “surprise”
• An unanticipated event or news occurs or announcement is made e.g. forward profit guidance, write-downs
• Once news is out, there’s less to speculate about – markets will often “buy the rumour, sell the fact”
• Professionals trying to 2ⁿᵈ guess the news and beat their peers – many then realise they guessed wrongly

If “everyone” thinks the market will do X, it almost certainly will not
• Markets often confound a cheery consensus by suddenly abandoning the consensus (prices move sharply)
• Participants respond totally differently to the same information at the same time – some buy, some sell
• At major turning points in markets, almost everyone is WRONG
Share price = EPS * PE ratio

• Bull markets:
  • Corporate profits rise – **positive EPS growth**
  • Investor sentiment is optimistic; we are prepared to pay **a higher PE** in anticipation of higher profits and less risk to our estimates
  • Greed and fear of “missing out” fuel rising share prices, until the last and most reluctant buyer capitulates and shouts “BUY”!

• Bear markets:
  • Corporate profits fall – **negative EPS growth**
  • Investor sentiment is pessimistic; we are prepared to pay **a lower PE** in anticipation of lower profits and more risk to our estimates
  • Fear of greater losses exaggerate falling share prices until the “day of no hope”; the last and most reluctant seller shouts “SELL”!
The “crowd” mostly loses or makes no money

Don’t rush to follow them!

• Euphoria and Panic
  – “Dumb Money” weak hands buy at the top from “Smart Money” strong hands (who buy at the bottom)
• Fear and Greed
  – Resistance = supply overwhelms demand
  – Support = demand overwhelms supply
• Markets think short-term but act long-term:
  – “Short-term, the market is a voting machine”; long-term, it’s a weighing machine” – Ben Graham
  – Prices reflect short-term popularity and sentiment, driven by often irrational emotions
  – In the long-term, prices “mean revert” to fundamental value to reflect underlying earnings
  – Price constantly oscillate around “value” (a line of linear regression)
• Straight-line thinking:
  – People have a bad habit of linear extrapolation of a recent trend
  – This leads to markets overshooting, both on the way up & down
  – Example: a high PE “market darling” which goes “ex-growth” may see its price collapse as the PE multiple contracts. As EPS growth estimates fall or stagnate, it can be hit by a “double whammy”
• Some famous investors concur:
  – “Be fearful when others are greedy & greedy when others are fearful” – Warren E Buffett
  – ”Buy on the cannons, sell on the trumpets” – Lord Nathan Rothschild
  – “I buy when everyone else is selling” – J Paul Getty
The cycle of markets – straight-line thinking

Cycles are caused by the way humans think; we extrapolate linearly and expect the future to be similar to the recent past.
Support & Resistance – Demand & Supply

Our emotions often work against us.

Solution: Have a plan, then follow it!
Financial services industry sells this

“Average returns from shares are 9–10% p.a.”

Fine print – please never read:
• Please don’t blame us if you lose money in bear markets or on our stock picks
• We’ll take our fees whatever happens
• You must stick with me regardless – I hate to lose clients
• Investing is not really so terribly complicated you can’t do it yourself
• Please don’t call to complain or ask awkward questions
Volatility and Risk

- Stocks on average rise 3 years in 4 and fall 1, but down year(s) can be very scary
- Academics say risk = volatility (measured by \( \sigma \) or sigma), but our risks are permanently losing investment capital or not having sufficient retirement income
- Statistical jargon: We “expect” say 9% average annual returns +/- up to 3\( \sigma \) (say 1\( \sigma \) = 18%) from shares @ a “confidence interval” of 99%
- In English: This means anywhere between –45% and +63% p.a. in 99.7% of all years!
- In CY 2008, the All Ords index lost 43.0% and > 50% from the high of 11/07 to 3/09
- Study and learn from history – we’ve always had bubbles and panic selloffs, especially during and after periods of low interest rates and high leverage
- Cook Pine Capital’s 2008 paper “Study of Fat–tail Risk” showed:
  - Textbook Gaussian (bell curve) distributions of returns greatly understate actual daily volatility
  - –3\( \sigma \) S&P 500 “down days” (a –3.5% daily move) “should” happen 27 times in 100 years, but they actually occurred 100 times in 81 years (1927–2008)
  - Daily falls of –4\( \sigma \) (–4.7%) or “1 in 100” year events actually occurred 43 times
  - > 5.8% falls in 1 day “should” have a probability of 0.00003% – they in fact occurred 40 times
  - [www.cookpinecapital.com/pdf/Study of Fat-tail Risk.pdf](http://www.cookpinecapital.com/pdf/Study of Fat-tail Risk.pdf) has the full paper (11 pages)
The reality is not a neat straight line to riches

During 20th century:
- DJIA had several sideways markets of 15–20+ years each
- Plenty of corrections to keep you awake, even in “good times”
- Bear markets always follow bull markets

Consider “sequencing risk” (sequence of annual returns) in early retirement years and “longevity risk” (you outlive your money)

Despite the high volatility, equities tend to outperform other asset classes over the long term

During sideways markets, buy & hold close to the index doesn’t give much capital gain
You need dividends or become an “active” investor (market timing and/or pick stocks)

During sideways periods, markets work off speculative excesses like debt–fuelled bubbles in asset prices
Some recommended books about investing and trading psychology

**Australian authors**

Colin Nicholson
- *Building Wealth Through Shares, The Psychology of Investing, Think like the Great Investors*

Matthew Kidman
- *Bull, Bears and a croupier*

Peter Thornhill
- *Motivated Money*

**International authors**

Dr Alexander Elder
- *Trading for a Living, Come into my Trading Room, Entries and Exits, Sell and Sell Short*

Eoin Treacy
- *Crowd Money; A practical guide to macro behavioural technical analysis*

Dr Brett Steenbarger
- *The Psychology of Trading*

Dan Gardner
- *Future Babble; Why expert predictions are next to worthless and you can do better*

Charles Mackay
- *Extraordinary Popular Delusions and the Madness of Crowds*

Geoff Colvin
- *Talent is Overrated; What really separates world class performers from everyone else*

Carmen M Reinhart and Kenneth S Rogoff
- *This time is different; Eight Centuries of Financial Folly*

Michael M Pompian
- *Behavioural Finance and Wealth Management; How to build optimal portfolios that account for investor biases*

Robert J Shiller
- *Irrational Exuberance*

Robert F Bruner and Sean D Carr
- *The Panic of 1907; Lessons learned from the market’s perfect storm*
Hopefully I was clearer than this man

“\textit{I know you think you understand what you thought I said but I'm not sure you realise that what you heard is not what I meant.}”

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