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Excellent article on Investor psychology & Market cycles based on Howard Marks' "Mastering the Market Cycle".

cc: @dmuthuk @Gautam__Baid

My fav pts ■

Mastering the Market Cycle : Howard Marks

"There are opportunities for us to tilt the investment odds in our favor by understanding the tendencies of markets and the reasons they wax and wane. By contrast, failing to understand the nature of markets may leave us too optimistic or pessimistic at precisely the wrong time."

"It is important to understand our investment environment and position our portfolios accordingly. This involves balancing the aggressiveness and defensiveness in our positions based on the future tendencies of markets (which is based on the cycle phases we observe today)."

Markets may misprice assets on a risk-adjusted basis as society swings along the pendulum of psychology.

Understanding risk
Risk in practice refers to the likelihood of permanent capital loss and the likelihood of missing out on potential gains. The latter is also known as opportunity risk. Risk implies we are unsure about what's about to unfold next and that there is a range of potential outcomes. We must always keep risk in mind when making decisions. This requires us to focus on both the tendencies and ranges of potential outcomes.

Thinking in cycles
Most investors do not have a proper appreciation for the features and significance of market cycles, and what it implies about future tendencies. Similarly, most investors have not lived through many cycles or read sufficient financial history to develop such knowledge advantages. Too often they see the investment environment as isolated events in the moment.

The nature of market cycles
Market cycles are like pendulums or tides that move back and forth. While their reasons, timing and degree of change may vary, Marks believes they are an inherent feature of the investing environment. Like a pendulum in motion, markets are unlikely to remain at fair-value indefinitely. Rather, it swings from underpriced to overpriced and vice versa.

Financial amnesia
Our inability to remember the past can enhance the strength of cycles. We are also quick to assume that this time is different. Furthermore, our asymmetrical attitudes to market gyrations can make it difficult to observe cycles in the moment.

Human nature and randomness
Randomness and human behavior contribute to the irregularity of cycles. Sometimes we develop simple explanations to make these events comprehensible, failing to recognize the full complexity and randomness that may characterize such events. Seeking such explanations may lead us to over extrapolate without evidence.

Complex reflexive systems
More generally, we should remember that financial markets are complex, reflexive systems. This is due in part to the nature of human participants in markets. Most good ideas in markets are unlikely to be infinitely or indefinitely scalable. Hence, ideas that generate abnormal profits tend to attract new capital that creates downward pressures on incumbent returns.

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The Technology cycle
It is helpful to think about technologies and innovation in cycles as well. Technologies are developed, diffused and later displaced by future iterations and alternatives. While technology can boost productivity and generate new demand, new technology can also create new competitors and disrupt the profit margins of incumbents.

The psychology cycle
Emotions and psychology influence and are influenced by economic and profit cycles. Marks notes that company, industry and macroeconomic fundamentals cannot fully explain the short-run gyrations that we observe in markets. Marks emphasizes that investor psychology tends to swing between greed and fear, optimism and pessimism, risk tolerance and risk aversion, credence and skepticism, and our urgency to buy and sell.

Mania and risk
Marks notes how positive events can lead to optimism and credulousness in investors and encourage greed and risk tolerance. Robert Shiller has similarly described this as the combination of feedback loops and irrational exuberance, where newfound expectations and enthusiasm, encourages investors to bid up and rationalize extraordinary growth in asset prices. By contrast, during periods of fear and pessimism, many face difficulties with identifying potential future value beyond the immediate-term.

An understanding of where attitudes to risk sits within the current investor psychology cycle can be a useful knowledge advantage. Markets may misprice assets on a risk-adjusted basis as society swings along the pendulum of psychology. Marks believes that the biggest source of investment risk is when investors believe that there are no risks at all.

Contrarianism
It is helpful to consider the extent to which optimism or pessimism is incorporated into current asset prices. Skepticism is needed when mass optimism or pessimism is in excess. Contrarianism at the right moments is an important ingredient for successful investing. Marks believes that the rational, analytical and unemotional investor that finds balance between defensiveness and aggressiveness, particularly during periods of mania, is more likely to find success.

Credit in action
Marks provides a simplified depiction of the credit cycle. Good economic times tend to lead to an expansion in riskier lending and investing. This is driven in part by increased optimism and risk-tolerance amongst investors and financiers. Over time, unwise lending leads to large losses and contribute to bad economic times. It is during these periods that investors and institutions become prudent and risk-averse. Such lending and investments help good economic times to re-emerge once again.

This tendency for riskier lending during good times is attributed to several structural and behavioral factors. In particular financiers are more likely to accept deals of lower yields and riskier structures to protect market share during booms. This is aided by the confidence, optimism and risk-tolerance that good economic times bring. Capital markets can be a good indicator of investor psychology for these reasons.

Fundamentals and psychology
Rarely do markets evaluate fundamentals or set prices without emotion. If they did, prices would fluctuate less than we observe today. Our tendency to extrapolate incorrectly and with emotion means we are liable to make poor investment decisions at precisely the wrong time. However, the markets cycle may reveal itself in various valuation metrics such as price to earnings ratios, capitalisation ratios and cash flow multiples.

While getting things wrong is an inevitable feature of investing, skillful asset selection and cycle positioning may help us to tilt the odds in our favor over time. Marks reminds readers to invest with a margin of safety, and to understand what the current cycles may imply about future tendencies. Ultimately, we can only rely on our estimate of intrinsic value, our capacity to persevere during periods of manic, and time for mis-pricing to correct.

Excellent pts ■

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My 2 cents - For individual investors, it's a futile effort to predict the Macro but there's a lot we can glean from what is already happening in the Mkts, and how we can posture our Portfolio for offense/defense (on the edges), especially when there's excessive fear/froth in Mkt

Inability to predict the Macro shouldn't stop us from learning more about Business, Credit & Economic cycles and being aware that they can affect Markets in both directions, and impacting the discount/premiums to the Valuations of Companies (far away from their intrinsic values).