How Worried Should Investors Truly Be?

Description

Talk about strange timing! Last weekend, right before this week's sharp market sell-off, the Motley Fool Money podcast featured an interview with Howard Marks, the influential money manager at Oaktree Capital. Marks has just released his second book, *Mastering the Market Cycle*, which I promptly bought and downloaded on Kindle and read over the (Canadian) Thanksgiving weekend.

Subtitled *Getting the Odds on Your Side*, the book is only Marks's second, following the 2011 publication of *The Most important Thing: Uncommon Sense for the Thoughtful Investor*. What was clear about the podcast and the book is that Marks felt that the current market cycle is closer to a top than bottom. In fact, late in September Motley Fool Money's lead podcaster Chris Hill titled a blog "How worried should we be about Howard Marks' Market Caution Warning?"

Maybe a little, it turns out, although at the time of that podcast Marks's mood was one of "cautious optimism." Since then the market seems to have shifted a bit more from optimism to caution. As it happens, Wednesday's 800-plus plunge in the Dow occurred just two days after I personally started to rebalance our portfolios, partly inspired by my weekend reading, so the new book was quite relevant.

Book publishing being what it is, and with much of it largely written in 2017, Marks doesn't come right out and declare that the market is near a top; authors tend to be aware that books need to stand up for a few years. However, a quick look at his web-based market commentaries underline his cautious approach. As Hill pointed out in his conversation with Tim Hanson, Marks's memos may not be quite as well known as Warren Buffett's, but he nevertheless has a strong following.

At age 72, Marks has seen more than his share of market cycles and claims to have been able to profit from most of the biggies: from the 1999 Tech Wreck to the 2007 Global Financial Crisis. In fact, he's been around long enough to remember the famous Nifty 50, which were perhaps analogous to today's mania for FANG stocks.

Every cycle is different, and while I saw little in the book that was devoted to the two most current investor fads, it certainly puts the modern mania for cannabis stocks and cryptocurrencies into sharp perspective.

The key insight is that investors have to strike a balance between aggressiveness and defensiveness. Cycle positioning is all about choosing between aggressiveness and defensiveness. But, Marks emphasizes, this has to be done despite the fact that “we can’t know what the ‘macro future’ has in store for us.”

He doesn’t put much stock into predictions, but what investors can do is “calibrate” their portfolios to at least tilt the odds in their favour. A lot of this is well known. More than once, Marks cites the famous Sir John Templeton quote that we should sell at the point of maximum optimism and buy at the point of maximum pessimism.

It’s easier said than done, of course. Few investors are emotionally equipped to do what great investors like Templeton and Marks can do. Markets seldom stay in a midpoint but tend to fluctuate wildly between euphoric and despondent extremes. (Think of your own emotions this week: were you feeling euphoric, despondent, or somewhere between?)

As Marks observes, for investors their “risk aversion goes all the way from inadequate to excessive”—inadequate near market tops when all seems rosy, and excessive when, as in late 2008 and early 2009, the world seems one step from financial Armageddon. Marks says that while writing in the fall of 2017, the S&P500 had roughly quadrupled after dividends from its March 2009 low.

I found Marks’s story of the three stages of a bull market useful, which he learned about in the early 1970s and describes as “one of the greatest gifts I was ever given.” In phase one of a bull market, only a few unusually perceptive people believe things will get better (think February 2009); in the second phase, most investors realize improvement is actually taking place; and in the third, “everyone concludes things will get better forever.”

Cannabis stock enthusiasts might want to take heed of this saying, although Marks wasn’t referring to that particular sector when he wrote this sentence: “Few things are as costly as paying for potential that turns out to have been overrated.” (Full disclosure, as I have written in this site before, I have a tiny speculative position in marijuana stocks, exclusively through ETFs.)

One thing is certain: cycles are inevitable. Marks devotes entire chapters to the cycle in profits, the credit cycle, the distressed debt cycle, the real estate cycle, and the pendulum of investor psychology. Near the end, he tells you how to put this all together, how to position portfolios for these cycles, and he addresses the limits of coping with them.

Marks observes that we generally see only one major cycle per decade, which seems relevant given that the current bull market has just passed its 10th anniversary. The chapter on the pendulum of investor psychology seems to me the crux of the book. Markets fluctuate between greed and fear because “*people* fluctuate between greed and fear,” he writes (his emphasis). As with the 1999-2000 tech wreck, people quickly go from “buy before you miss out” to “sell before it goes to zero.” And few investors are capable of “staking out a midpoint position that balances greed and fear.”

He has a unique view on risk, too; investing risk doesn't come primarily from the economy, companies, or securities, but from the behaviour of market participants (i.e., and again, *people*.). But "so do most of the opportunities for exceptional returns."

But his "number one" piece of investment wisdom he says can be summarized in just 14 words: "What the wise man does in the beginning, the fool does in the end." Or, to return to Warren Buffett, "First the innovator, then the imitator, then the idiot."

Better to be a Fool than an idiot!

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