



## Irrational Apprehension

By Brian D. Singer, CFA

The last quarter century provided investors with a sublime environment of rising asset prices, whether in stocks, bonds or real estate. A backdrop of declining inflation, relatively low volatility and accommodative central banks turned nearly everyone who dipped their toe in the markets into a “knowledgeable” investor. It was an easy time for savers, who sought protection over accumulation of capital, to become investors, who sought accumulation over protection. As asset prices continued to rise, the decision was easy. Missed asset price increases characterized risk rather than loss of principal.

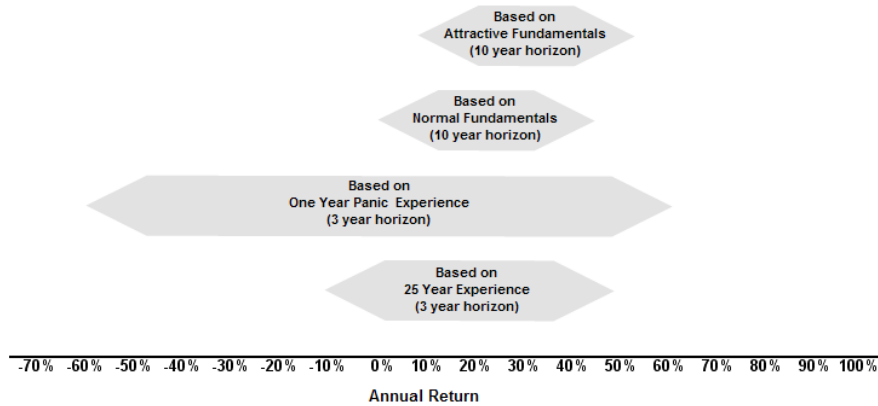
Where are these investors now? The harsh reality of investing opened the eyes of those who had been lulled into the fallacy of steadily rising prices. They found out, as their brethren of the second quarter of the last century had, that *investing is risky*.

Any entrepreneur who starts a company thinks long and hard about opportunities and potential losses. An entrepreneur’s risk is real. Any revenue swing or cost jump requires immediate attention. But in an atmosphere of steadily rising asset prices, investing in paper – stocks and bonds – somehow resulted in a shocking detachment from the reality of risk. Investments became numbers that went up and down in the newspaper or on a computer screen. At the click of a button, the bad could be sold and made to go away and the future made bright again.

Not anymore. Suddenly and starkly, investors have been reminded without mercy that their understanding of risk was terribly flawed.

Given the experience of the last 25 years, it was reasonable that investors’ perception of risk resulted in expectations that were far more positive than reality. The following chart shows various return outlooks based on investors’ expectations and their investment horizons. The lowest bar represents the three-year outlook that investors would have if they based their expectations on the last 25 years of market performance, through the equity market peak in 2007. These 25 years provided average annual returns of 17% and a fairly narrow range of return outcomes. The lowest bar shows what investors would anticipate over the next three years if the future were to deliver equity returns consistent with the prior benign 25-year period. Interestingly, investors would expect that very few returns would be negative.

## Range of Annual Return Expectations Based on Historical Experience and Fundamental Analysis



With expectations of returns like these, the general public delved into equities, becoming “investors” with a flawed – but understandable – perception of risk. They became cocktail party investors, doing what was fashionable and had until recently been rewarded handsomely.

Unfortunately, the last year altered that perception of risk dramatically, from one of “irrational exuberance” to that of “irrational apprehension.” Option markets indicate that the market expects volatility in excess of 50%. Assuming a zero percent return for the next three years with a high range of outcomes based on recent extreme volatility results in a three-year range of annual equity market return expectations that looks more like the second bar from the bottom.

But neither the exuberance nor the apprehension is appropriate. Rather, fundamental analysis of assets is the only appropriate course in formulating expectations on which to base investment decisions. Investing is not about predicting the future; it is about determining what an asset or collection of assets (think of an entrepreneur’s company) is worth.

When sharp, short-term price fluctuations impact long-term investment decisions, there is a greater tendency for investors to panic. Titular investors will freeze and stop investing, often for extended periods of time. When many investors have adopted the same strategies, as was the case with the exuberance of the last two-and-a-half decades, investor panic can lead to systemic crisis. Such panic will extend well beyond the catalyzing event, leading to all manner of assets – both good and bad – to be inappropriately priced.

As Lao Tzu commented in the 6<sup>th</sup> century BCE, “Those who have knowledge, don’t predict. Those who predict don’t have knowledge.” Successful investors are well disposed to seek the fundamental value of an asset rather than attempt to predict what someone else may or may not pay in the future. Fundamental analysis results in “normal” expectations for returns of about 8.5% annually with a volatility of about 15%, as developed by Singer and Terhaar, over longer horizons of at least 10 years.<sup>1</sup> The third range from the bottom shows likely outcomes over an appropriately long, ten-year investment horizon and based on “normal,” fundamental

<sup>1</sup> *Economic Foundations of Capital Market Returns*, Singer, Brian D. & Kevin Terhaar, Research Foundation of The CFA Institute, September 1997.

analysis - different from the exuberance of the last two-and-half decades and very different from the apprehension of today.

Today, however, is not normal. Prices have dropped by 40% from a year ago. Equity prices, as well as other asset prices, have gone from being somewhat high relative to fundamental values to very cheap. This is an environment of attractive potential returns for investors - an environment of opportunity. The topmost range bar indicates potential 10-year outcomes for investors given today's attractive prices, boosting the expected annual return outlook from 8.5% to about 12%. Cumulatively, over the next ten years, this return increment would add over 40% to invested wealth. Such opportunities came in the depression and to some degree in the 1970s, or roughly once every 40 years. It is unlikely that investors will get the same opportunity to invest at such attractive prices in their lifetimes again. Most interesting, the investment opportunity over the next ten years is superior to the euphoria of the last 25 years.

But this is not an environment that will provide rewards in the short run. Volatility will be the norm in the near-term. Investors with a mid- to high-level risk tolerance should not be worried about past or dissuaded by future asset price declines. Today, most investors and market pundits seem worried about the latest 10% wiggle in the market. Rather than decry a 15% to 20% drop in net worth as an investment failure, realize that, unless one is prescient, this is simply a part of investing and taking risk. Those with long investment horizons, a sense of fundamental value (as opposed to the fool's errand of predicting what someone will pay tomorrow), and an appreciation of investment risk should realize that now is the time to retain or take risk; not when friends approve of investment decisions over a cocktail. Now is a rare opportunity to invest - seize it before it disappears. Likewise, this is not the time to bail out of previously established equity positions.

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