BPM Berlin Portfolio Management

A guest contribution (1. August 2017) by Uwe Günther

n-tv.de and

n-tv Teleborse.de

Many investors become irrational, or

Psycho-party at the stock markets

Many investors seem not to have learned much in the crisis of the years 2000-2003 and 2008/09. They consequently ignore warnings, and will have to pay for this.

The stock market and psychology are known to be closely related. Most investors are aware of the interplay of greed and fear, of rationality and irrational behavior. There is a discipline called "behavioral finance" which means nothing but investor psychology.

Many investors believe they belong to the group of rational, deliberate and carefully balanced market participants - as if they were a so-called Homo Economics. In reality, however, the capital market participants - both professionals and private investors - are increasingly torn between various poles. Psychology calls this “cognitive dissonance”: a state of feeling perceived as unpleasant, which arises from the fact that a person has several perceptions, thoughts, opinions, attitudes, wishes, or intentions that are less and less compatible with each other. One is in imbalance and struggles to regain balance.

Examples for this state of mind include:

1. Many investors still remember their emotional state in the years 2000 and 2008, the stock market peaks at that time, and the subsequent crashes after the euphoria that turned out to be a "stock market bubble". Despite this knowledge, they are now heavily invested in mostly over-valued investments.
2. "This time it is different" was probably the main slogan that justified obscure valuation figures such as cash-burn rates during the dotcom bubble. Despite this knowledge, they are now again invested.
3. Today, only a small share of higher valuations, such as price-earnings ratios, come from an increase in the actual business activities and profits. An ever-longer debt lever (also used for share buybacks) helps improve these ratios. Despite this knowledge, they are now again invested.
4. Discounting, lack of pension provisions and creative accounting are increasingly used to obtain superficially acceptable valuations. Despite this knowledge, they are now again invested.

Is it really different this time?

This time the justification for the exaggerated valuations is: equities are adequately valued because the bond yields are so low. In case of a direct comparison between the two asset classes, a higher valuation of shares is justified, since bonds are also historically highly valued and the future corporate profits therefore have to be discounted with lower interest rates. However, at the same time the same experts criticize the activities of the central banks for that their irresponsible monetary policy is responsible for the creation of gigantic misallocations, annuities and company-zombies. This deepens the impression that today's low interest rates cannot cover the real risks of the future.

In the standard valuation formulas analysts expect the market rate, i.e. the equilibrium price, to be defined by supply and demand. However, the flood of liquidity caused by monetary policy currently provides an artificial excess-demand for money investments with low price stability. Although market interest rates continue to be driven by supply and demand, this price formation is distorted by the gigantic supply of bank liquidity and unjustified low interest rates. In this respect, it seems dangerous to justify the high valuations with the artificially low interest rates.

This means that the majority of current standard of valuations is built on sand. If the real risks were correctly priced in the borrowing conditions of the borrowers and the distortions caused by the central banks was removed, a massive downward revaluation of the stocks, even by classic valuation methods, stands on the agenda.

The contrary, obscure valuation argument only holds if the interest rate manipulation by the central banks can be sustained in the long term.

Investors who justify their own investments actually deny the effectiveness of economic laws. Advisors and asset managers are exposing their customers to a historically unique risk that does not face adequate opportunities. The upward normalization of interest rates and risk spreads as well as the simultaneous downward correction of the stock market valuation, which is inevitably associated with it, has the potential to become a long-term asset killer as it would hit bonds and stocks at the same time. The psycho-party at the financial markets threatens to end again with a painful hangover.

Uwe Günther is the founder and managing director of BPM - Berlin Portfolio Management GmbH

Disclaimer

Disclaimer

This publication is for information purposes only and is intended for use by the recipient. It does not constitute an offer or solicitation on the part of or on behalf of BPM - Berlin Portfolio Management GmbH for the purchase or sale of securities or investment funds. The information contained in this publication has been compiled from sources which are considered reliable. However, BPM - Berlin Portfolio Management GmbH makes no guarantee as to its reliability and completeness and declines any liability for losses resulting from the use of this information.

www.berlin-pm.com