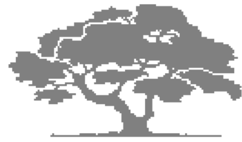
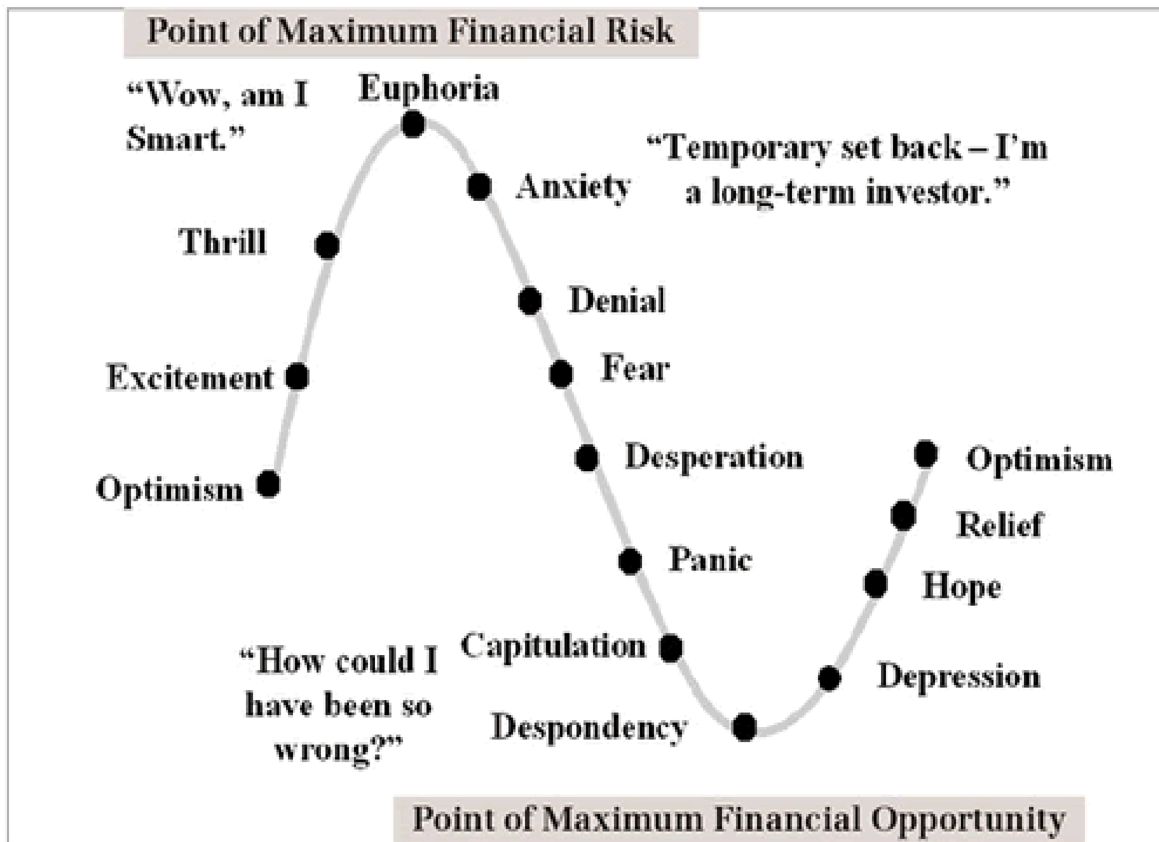



January 2013

**INVESTMENT PERSPECTIVES**

**The Psychology of Investment Cycles**

For all types of investments, there is a cycle that runs from the "Point of Maximum Financial Opportunity" through 6 or 7 stages to the "Point of Maximum Financial Risk", and then back again. The chart below shows the various stages of the investment cycle:



[1]

[1] Mymoneyblog.com

## Emotional Cycle

In the long term, stocks are dependent on economic growth and corporate earnings, but short term fluctuations can be driven by news headlines and investors level of confidence regarding the future. Similar to the business cycle, which fluctuates between recession and expansion, there is also a less acknowledged cycle in investing: this is the emotional cycle. The emotional cycle as pictured in the graph on the previous page moves from the lows of capitulation and despondency to euphoric highs. These emotional cycles affect all types of investments: stocks, houses, commodities, bonds, and even tulip poppies at a time in history.

Most investors have now experienced two full stock market cycles: 1) the stock market (as measured by the S&P 500 Index) that reached a high on March 10, 2000 of 1456 before dropping to a low of 884 on October 10, 2002, and 2) the stock market that reached a high on October 10, 2007 of 1562 before declining to 677 on March 9, 2009[2]. Both events shaped the current market we have now. The shifts between stages in the market do not happen linearly and they do not happen in set time increments. While we never know exactly when each stage will occur, we do feel that we can assess where we are now, and how the market may react to the next stage. Currently, it appears that the scars of 2008/2009 run deep and most investors have chosen to "hide out" in cash or bonds in order to protect themselves while waiting for the clouds to lift.

## The Credit Cycle

In some ways the emotional cycle of markets and the credit cycle are inexplicably linked. Availability of credit starts as a useful resource for the economy - people can get access to homes, farm land, and stocks on margin, all more easily than in times of tight credit. However, as investments rise in value, investors become more positive about the future value of assets, and are thus more willing to increase their debt levels. Banks become more willing to lend as they reduce their lending qualifications as demand for new loans rises. Unfortunately, we know that this euphoria combined with easy credit tends to eventually end poorly and causes panic and forced selling of investments as assets fall in value and more collateral is not available to back the loans. Prudent investors ensure that they are not tempted by unwise investments during euphoric times.

## The Recent Past

While the Great Recession in the United States officially ended in June 2009 and the stock market as measured by the S&P 500 Index has more than doubled from the March 2009 lows [3], many investors have not benefited from this recovery. The negative psychological impact of losses incurred in the 2008/2009 downturn has contributed to a short-term focus on safety at the expense of attractive investment opportunities looking out longer-term. Despite record low yields on bond investments (the benchmark 10 year Treasury note ended the year yielding

[2] S&P 500 from Telemet charts
[3] +115% from Telemet

1.76%) and the prospect for negative returns should yields increase, there continues to be net inflows into bonds based on the perception and preference for safety. According to the Investment Company Institute, a mutual fund trade group, since the end of 2007 net inflows to bond mutual funds has been $1.08 trillion – a sharp contrast to the $541 billion in net outflows from domestic stock funds. Also, investors with sizable cash balances are willing to accept *negative* inflation-adjusted returns for the allure of safety. In our view, these examples are evidence that the consensus investing mindset is still largely characterized by fear, anxiety and despondency, as many investors ignore much of the progress made thus far in the economy and stock market recovery during the last few years. Based on the emotional investing chart on the first page, as contrarian investors, we believe there will be considerable opportunities over the next few years as we move to the next stage on the continuum.

## The Future

In our view, general doubts and anxieties about the state of the economy and stock markets will eventually be replaced with a growing recognition of the slow, albeit steady, progress that has been made in recent years. A shift in sentiment among various economic participants including consumers, businesses, government policy officials, and investors should lead to increased confidence in the sustainability of the economic cycle and stock market recovery. For investors, in particular, improved confidence could translate into less focus on shorter term, "safe haven" investments (i.e. cash and bonds) and an increased willingness to pursue longer-term investment opportunities (i.e. stocks). As investment time horizons lengthen, stock market valuations should increase as investors are willing to pay more for companies based on the expectation of a more optimistic outlook. Based on 2013 consensus earnings estimates[4], the S&P 500 Index currently trades at a 13.3 price-to-earnings multiple, which is lower than the long-term historical average of 15 times earnings. In sum, we see the potential for higher valuations for stocks based upon our expectation of a change in sentiment away from anxiety and fear to increased confidence and hope in the future.

From reading the headlines today, it may be hard for some to fathom that we see hope and optimism right around the corner. The Fiscal Cliff, European Debt Crisis, high unemployment and fear of the next recession, all have led the average investor to "hunker down" and wait until the dust settles.

We see green shoots all around us:

- Housing is poised to be a significant contributor to economic growth again after waning for 5+ years.[5]
- Consumer confidence is rising, which has led to increased consumer spending. [6]
- Household debt as a percentage of personal income is back to levels not seen since the early 1990s. Low interest rates are providing consumers with the opportunity to

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[4] Thomson Reuters
[5] Bureau of Economic Analysis
[6] The Conference Board

refinance mortgages at historically low rates which means more cash in their pockets each month. [7]
- Low interest rates also enables companies to refinance debt which lowers their cost of doing business.
- Bank lending to small and medium businesses is expanding again.[8]
- The labor force has been growing over the past year whereas it did not grow early in the recovery.[9]

As investors shift from worrying about day-to-day headlines and start thinking longer-term, we believe that we will see a shift to investing in stocks rather than bonds. We believe the tide of money that will flow to stocks will cause a powerful move to higher stock market valuations.

There will undoubtedly be temporary pullbacks from time-to-time. The next unknown crisis may be right around the corner, but the important thing to remember is that this will pass, and we will be looking at pullbacks as an opportunity to buy high quality stocks at attractive prices.

Eventually, perhaps in two to three years from now, the final stages of the current bull market will begin. At that time, many people will claim that it's the best time to invest as it's finally "safe". People will be overly confident and many will boast about their amazing stock market returns. Highflying stocks will move higher and higher, and expectations will grow greater and greater. There will be discussions of a new paradigm that seems to make sense.

At Hutchinson Capital Management, your portfolio may well underperform the markets as we eventually reach the euphoric stage of the cycle. Also, you will see your portfolio's allocation to cash grow as we find fewer stocks that meet our value and quality criteria. While many investors will be fearless, this is the time to be the most cautious.

## Conclusion

It is very important for all investors to be aware of economic cycles worldwide as well as the psychological cycle as it goes through its various stages discussed herein. At Hutchinson Capital Management, we focus on preservation of our clients' capital through each phase of both cycles. To oversimplify, our focus is to buy undervalued companies when prices are low and to sell overvalued companies when prices are high. We believe that adherence to a disciplined investment approach based upon value, quality, and contrarian principles is critical regardless of where we are in the economic and psychological cycles.

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[7] As of 2Q 2012, Source: Federal Reserve
[8] [9] Source: Federal Reserve

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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