

The art of ignoring the Pendulum's Swing

Things are never as good - or bad - as they seem

By Dan Richards

Dan Richards is president of Strategic Imperatives. He is a faculty member in the MBA program at the Rotman School at the University of Toronto. richards@getkeepclients.com

Occasionally, words of wisdom stay with us and remain relevant decades later. When I was in business school in the 1970s, my finance professor used a phrase that I find useful in markets like the one we're in today: "The pendulum never stops in the middle."

He was talking about market valuations and investor sentiment, and the reality that markets inevitably swing from one extreme to another - from periods of outlandishly elevated valuations to ridiculously beaten-down levels, from periods of unquestioning euphoria to absolute pessimism.

The adage applies in lots of other cases as well.

Look at the market's and the media's attitude to risk and leverage. Not long ago, companies that were fiscally conservative and didn't borrow to the hilt to boost profits were criticized for failing to maximize shareholder value; you may recall some of the commentary about the failure of Canadian will when foreign companies were outbidding our domestic competitors for



acquisitions. And many articles were written about how Canadian banks had fallen behind in global rankings, as they limited themselves to careful, small-scale acquisitions and rejected large bold moves.

By contrast, in today's environment, even prudent risk has become a dirty word. Just a few weeks ago, the most popular article in the online New York Times portrayed Canadian banks as the model for the global banking system - a notion that six months ago would have been absurd.

From pitied to paragon is common when the pendulum swings.

Consider investors' attitudes to owning resource stocks. Not long ago loading up on these was all that many investors wanted to discuss. Today,

those same investors don't want to hear about owning resources.

This is also reflected in expectations on oil prices. A year ago, the "peak oil" theory held sway and demand from China and India was going to push oil to \$200 (U.S.) by year-end. Today, we've begun to hear about the "peak demand theory," the view that demand for oil peaked last year and we'll never see demand at that level again. With the benefit of hindsight, the first forecast is now clearly absurd - as, almost certainly, the second will prove to be.

Finally, think about the wild swing in consumer sentiment on appropriate spending that's taken place in the span of just a few months - from the norm of lavish expenditure to "the new frugality."

While the stock market may be efficient and rational in the mid and long term, in the near term the "swinging of the pendulum" creates opportunities for companies and investors who maintain perspective.

That was true 30 years ago, and it's true today. That's because the notion of the pendulum of market sentiment swinging from one extreme to the other captures two of the most important and widely recognized truths about investing.

The first truth is that what really drives markets at their extremes are the twin emotions of greed on the upside and fear on the downside. Both can be costly - and it takes real discipline and

resolve to withstand the forces of those emotions as the pendulum moves through its arc.

The second truth is that the costliest advice for investors is "it's different this time." Seasoned investors know it's never different. Investors who listened to market prophets saying that the historical rules didn't apply to tech stocks in 2000 and resource stocks a year ago ended up paying a huge price.

And chances are that those investors taking counsel from the most extreme voices of doom today will pay a similar price in wrong-headed investment strategies and missed opportunities. It would be foolish to deny that the global economy and stock markets are facing formidable challenges. That said, open markets, the spirit of innovation and the entrepreneurial ethic have demonstrated remarkable resilience in the past in working through periods that seemed at the time as dark as the one we're in today.

We may not be all the way to the extreme of despair and pessimism, but we are almost certainly well past the midpoint - and into an area we may remember more fondly years from now. We'll see that the drastic shift in sentiment has created significant value for those disciplined and bold enough to look past the swinging of the pendulum.

Special to the Globe and Mail