

Strategic Investing Through the Cycles

Address by Colin Nicholson
AIA Conference 8 August 2016

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discussion and education**

**They are neither intended, nor are they suitable, to be
acted upon as investment advice**

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I am not a licensed investment adviser

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Strategic Objectives

Enough income to live comfortably in retirement

Capital to fund aged care and end-of-life medical costs

Maybe capital to leave to family

Key Strategic Risks

Inflation risk – the money illusion

Longevity risk – we outlive our capital

Only growth assets can deal with those risks, which introduces

Market risk – fluctuations in the value of our capital

Trying to avoid market risk magnifies the other two risks...

Why Accept Market Risk?

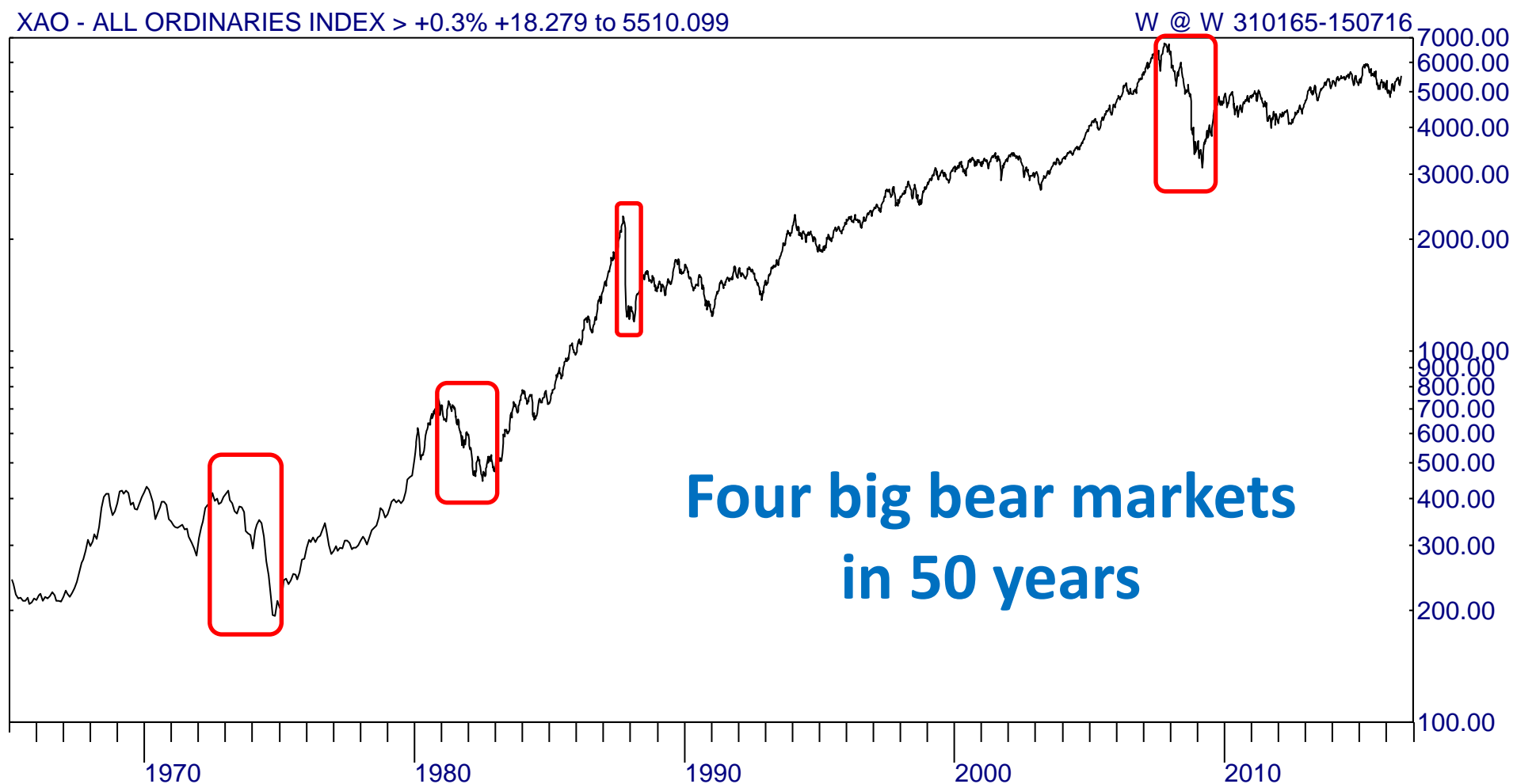
Stocks beat bonds over the long term

Stocks beat inflation better than bonds

Annualised Percentage Total Return 1900 – 2000			\$1 invested 1900 would by 2000 have grown to	
	Stocks	Bonds	Stocks	Bonds
Australia				
Nominal	11.9%	5.2%	\$85,475	\$167
Real	7.5%	1.1%	\$ 1,487	\$ 3

Dimson, Marsh & Staunton *Triumph of the Optimists*

Big Bear Markets



Big Bear Markets

- Follow economic booms
- Become manias and bubbles
- End in a financial crisis

Big bear markets are what we need a strategy to deal with

Small Bear Markets



Small Bear Markets

Are corrections in multi-year expansions that **do not**:

- Involve economic booms
- Lead to manias and bubbles
- Involve a financial crisis

They can generally be managed using

- Active risk management or
- Buy-and-hold strategies

Big Bear Markets

Historians see each event as unique - the details are different each time

Economists and investors search for patterns - systematic relationships between the crisis and its precursors...

So their development can be observed and managed

Big Bear Markets

Follow booms that become manias and bubbles leading to a financial crisis

The business cycle underlies any boom but not all business cycles create booms that lead to a financial crisis – and a **big bear market**

How a Boom Develops

- Economic outlook in at least one sector improves
- Anticipated profit opportunities improve
- Firms and individuals borrow anticipating increased profits
- Economic growth quickens
- The profit share of GDP rises
- There is a feedback to even greater optimism

In The Stock Market Booms Often Develop This Way

- The surprising success of an IPO with multiple oversubscriptions and a big stag profit
- This leads to more IPOs, often of lesser quality, with speculators looking to find the next hugely successful one
- Likewise it may be a stock that rises stratospherically, so
- Speculators rush second rank and rubbish stocks, looking for the next one

Booms Become Dangerous When

- Investors become traders – focus is totally on the price of the stock, not the rate of return from the business
- Many first-timers come into the stock market
- Speculation becomes rampant
- Conservative standards of valuation are abandoned
- Increased use of debt to boost returns
- All based on it being different this time – a new era or paradigm

Know the many signs of rampant speculation and watch for them

Big Bear Markets - Strategies

Strategy One: Buy-and-Hold

- Index Fund
- Disciplined investor managing a portfolio

Strategy Two: Market Timing

- Invest in bull markets; be out of big bear markets

Strategy One: Buy-and-Hold

You will have to hold your nerve through the bear market...



Strategy One: Buy-and-Hold

You will have to sit through the bear market...

Index Fund Approach

- You live off the dividends
- You hold two years living expenses in cash (earning interest)

You don't need to worry about stock selection

Biggest mistake: you panic and sell during the bear market

Strategy One: Buy-and-Hold

You will have to sit through the bear market...

Disciplined Investor Managing a Portfolio

- You live off the dividends
- You hold two years living expenses in cash (earning interest)

Stock selection skills are essential

Biggest mistake: you panic and sell during the bear market

Equally big mistake: you hold stocks that fail or never recover

Strategy One: Buy-and-Hold

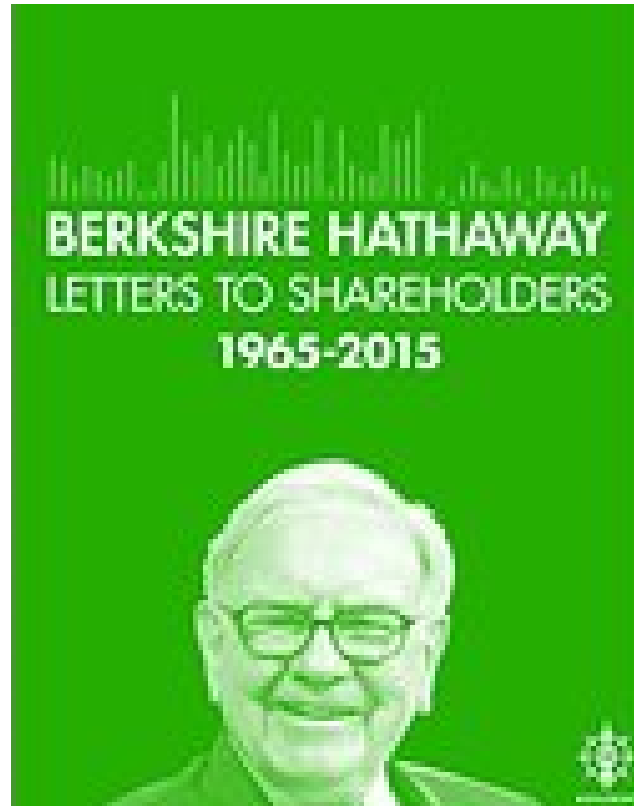
Disciplined Investor Managing a Portfolio

Stock selection skills are essential

- Portfolio is diversified – more than 10, less than 30 stocks
 - no more than two stocks in an industry
- Companies with a history of rising earnings and dividends
- With a good return on equity using little debt (safely financed)
- Are simple businesses with a sustainable competitive advantage
- That are well managed
- Bought at a price that is low relative to intrinsic value

Avoid: Very cyclical businesses, IPOs and new businesses, resources explorers, biotech developers, technology start-ups and most turn-arounds

The best book on investing in great businesses



Strategy Two: Market Timing

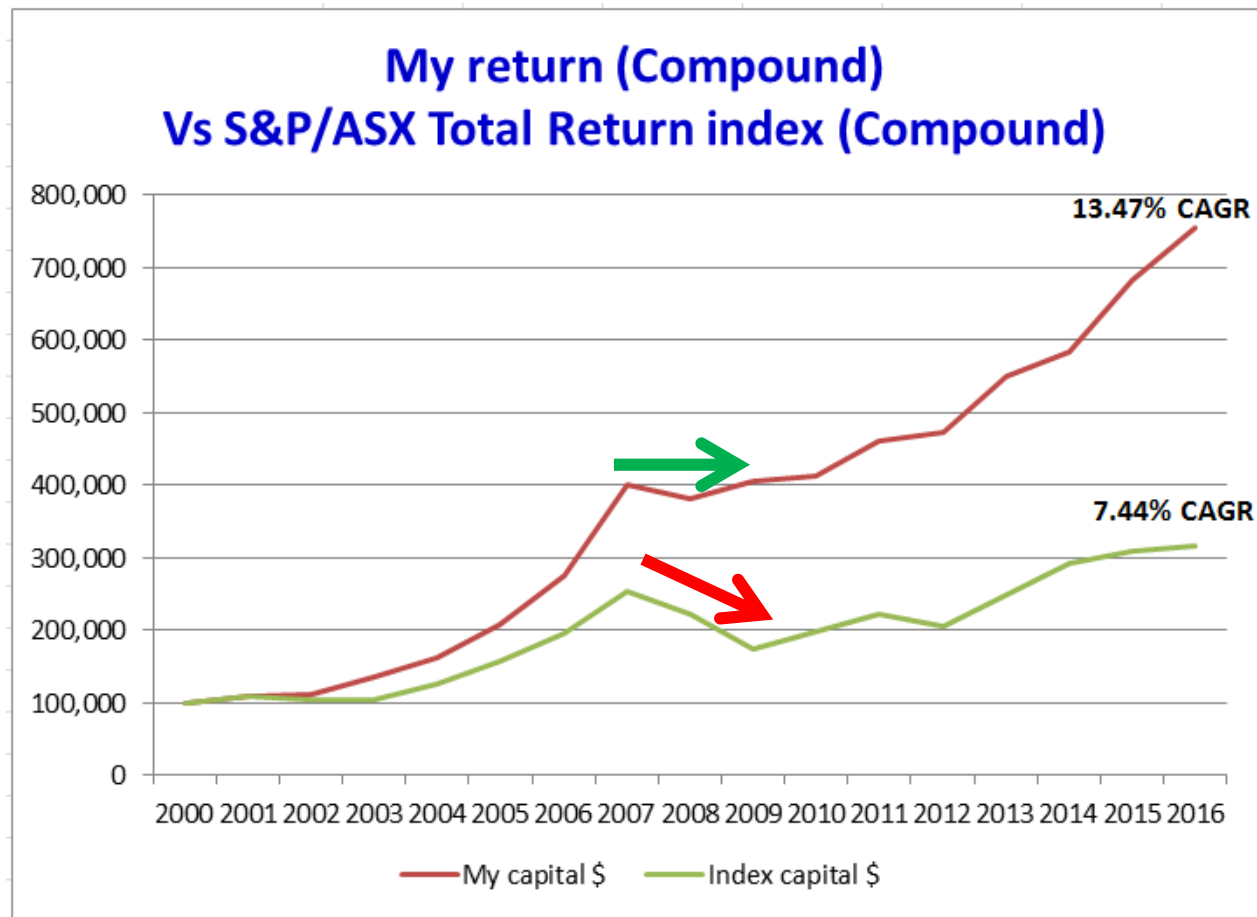
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Strategy Two: Market Timing

This is how it works out – financial years:



Strategy Two: Market Timing

You will be able to **enjoy the bear market...**

You will not have dividends to live off...

But you will have a large cash holding (earning interest)

And to invest at prices maybe 50% lower

You must be able to see the big bear market coming

You must be prepared to sell everything and pay any tax (buy back at around half the price)

First big mistake Not acting by the time bear market begins

Second big mistake Not buying back when the market has fallen 50%

Strategy Two: Market Timing

You must be able to see the big bear market coming

This requires...

- A wide reading of financial history
- An awareness of what is happening around us
- Recognising development of a boom that morphs into a mania and bubble
- A contrarian mindset – constantly questioning the common view

Strategy Two: Market Timing

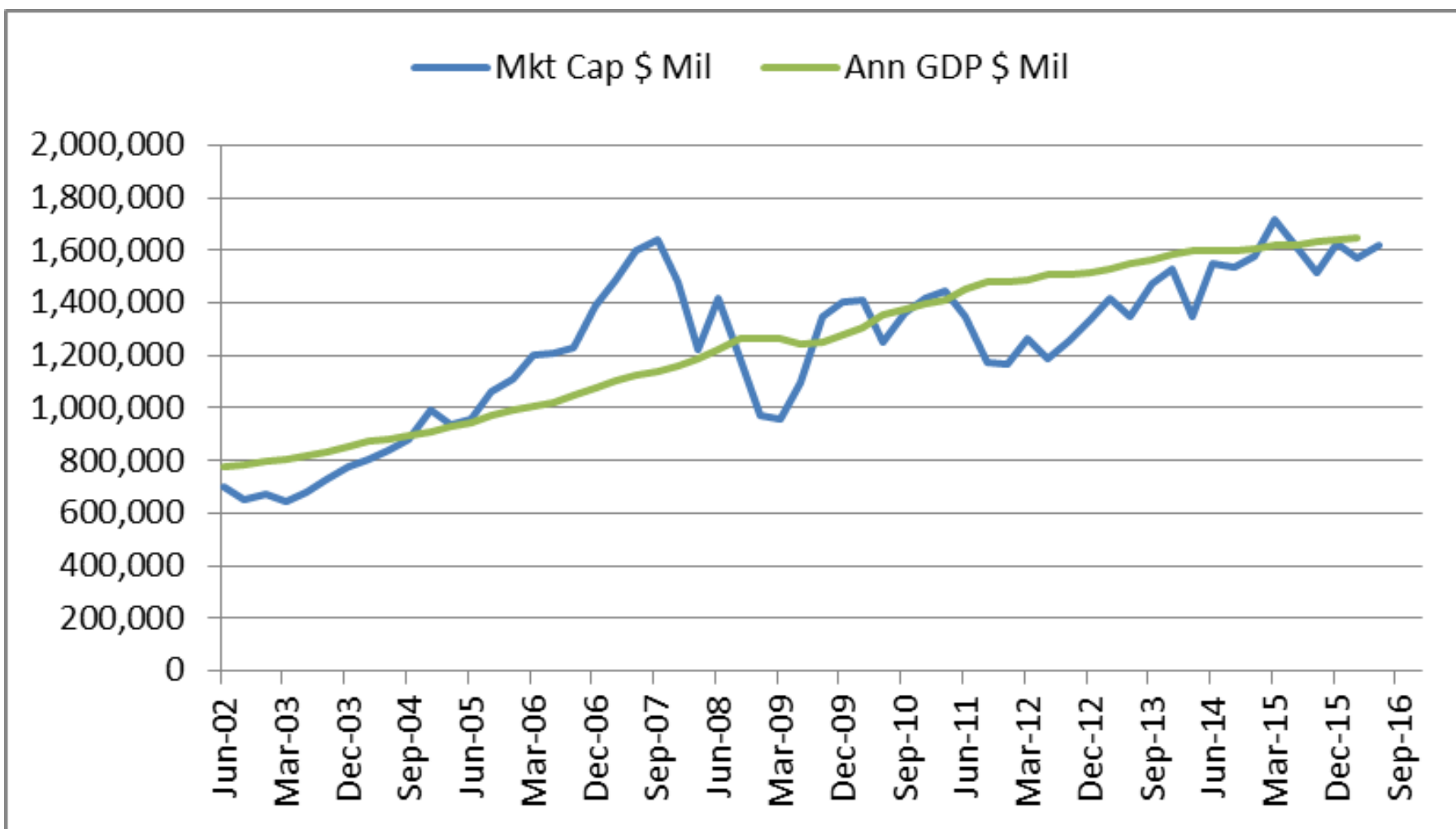
The main indications to look for:

- New era or new paradigm theories underlie the boom
- Commentators saying it is different this time
- A blue-chip boom + many IPOs + government privatisations
- This stimulates a rush into secondary issues in hot sectors
- And a rush to market by low grade IPOs, often at inflated prices
- Speculative stocks from last boom switch to new hot sectors (backdoor listings)
- Increased merger and acquisition activity
- Implicit government support for the market (various forms)
- Development of new institutions to circumvent regulations
- Deregulation or liberalisation creating new opportunities

Strategy Two: Market Timing

The main indications to look for (continued):

- Development of many close substitutes for money
- In low interest rate environments, investors chase yields, buying more complex products they don't understand
- Herd behaviour among gullible novices who begin speculating
- Increased marketing of expensive trading courses and systems to beginners
- Increased margin lending and use of debt to speculate
- New types of derivatives appear and margin trading increases
- Conventional standards of valuation are disregarded
- Significant fundamental overvaluation (high PE and low DY)
- Total market capitalisation rises well above GNP



Strategy Two: Market Timing

The main indications to look for (continued):

- Increased volatility in the stock market
- Fewer stocks driving the market up towards the end
- High levels of corporate debt, often hidden off balance sheet
- Readily available and cheap credit = undisciplined lending = little or no documentation or credit checking
- Commercial construction boom (world's highest building)
- Increased media coverage - Market at the start of the news
- Stockbrokers expand and go on recruitment sprees
- Conspicuous spending and lavish behaviour by some companies
- Interest rates relatively high

Each time some details are different, but the theme never changes

Questions?

