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Equity Investing

By: R. Stewart Eads, CFA

President

Eads & Heald Investment Counsel

www.EadsHeald.com

Chapter 4: Investors Always Fight the Last Battle

Investors are first and foremost, living, breathing and emotional human beings. Generally, they are skeptical and rather cynical. At times they can become extremely euphoric and greedy while at other times they are very fearful. The extremes of stock market emotion are "euphoria" and "despair." During euphoria, everything is going well and, seemingly can never go wrong again. However, during despair nothing is going right and there is little chance that the market will ever be healthy again -- at least not within any meaningful time frame. There are just too many long-term problems around.

The stock market is an upward meandering beast that fluctuates between euphoria and despair as it meanders upward over the very long term. Investors tend to believe that whatever major dynamic currently prevails (good or bad) it will likely be around for a very long time. Even when a trend change (for the better or worse) does occur, investors tend to see the change as only sporadic and believe that the major underlying fundamentals will not change. For example, even as inflation steadily moved upward from the mid-1960's, investors kept investing as if inflation was still non-existent. This expectation of continued low inflation continued until the OPEC oil embargo hit in the fall of 1973 and left no doubt that inflation was a problem. Conversely, the OPEC group began to fall apart in the early 1980's, and as other inflationary forces had largely expended themselves, inflation dropped markedly. However, many economists and investors continued to expect inflation to come roaring back because of the huge federal budget deficits.

As a general rule, investors seem to have a tendency to not accept a major structural change until 5-7 years after the true inflection point. This is a good working assumption as it pertains to various models and procedures throughout these articles.

In investing, simple truths are always very valuable. Convolved and complicated theories are usually wrong. One simple truth, as stated above, is that investors always tend to extrapolate history or, in other words, continue to fight the last battle. Dramatically increasing oil prices left no doubt about the direction of inflation. Although Growth stocks benefited much more than Value stocks from declining inflation, Growth stocks did not become the preferred equity style until approximately the end of 1988 when investors were finally able to accept that high inflation was gone....at least for a time.

To summarize, a good rule of thumb might be that investors tend to extrapolate a major trend event for 5-7 years after it has actually ended. However, to be smarter than the masses (i.e., early) can result in several years of investment frustration. Probably, the best advice is to realize that most investors will stick with an old trend far too long and act accordingly.