MARKET CYCLES: HOW THEY WORK AND HOW TO PROFIT FROM THEM

AN INDEPTH STUDY OF MARKET CYCLES

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“The market is a pendulum that forever swing between unsustainable optimism and unjustified pessimism”
Benjamin Graham

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The Art Of Compounding: Knowledge And Investments

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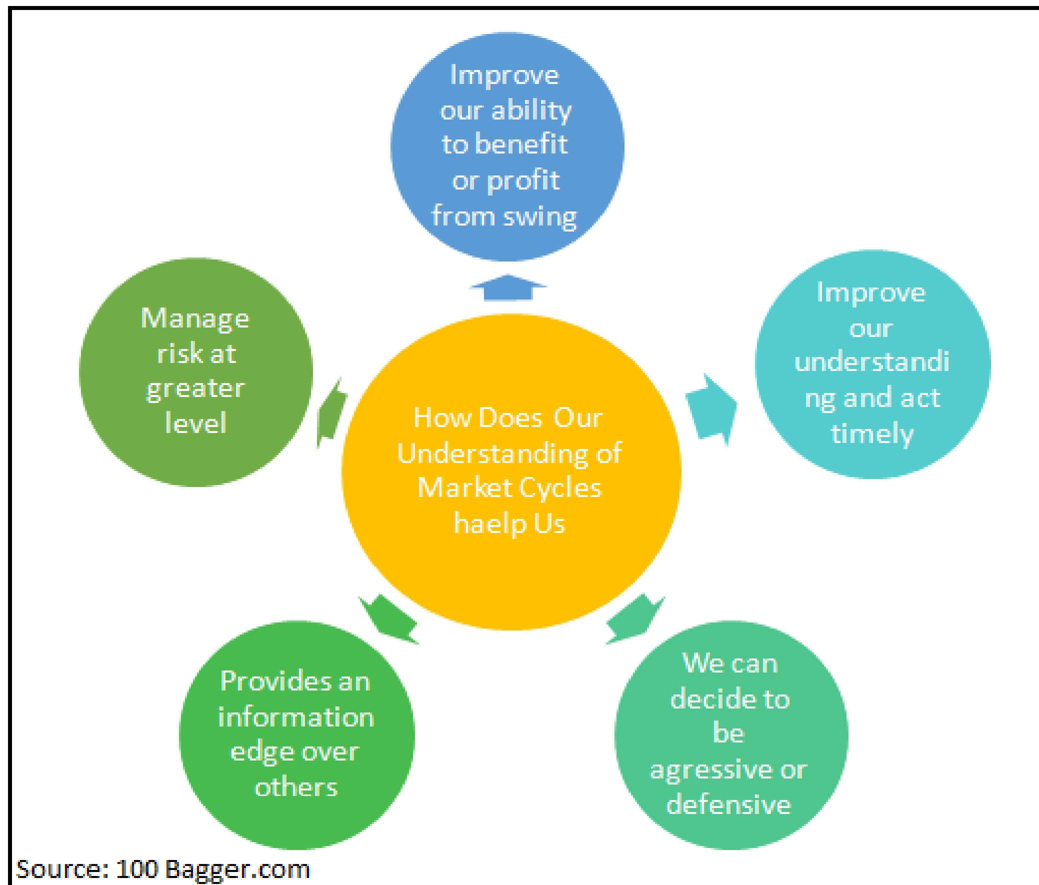
Chapter 1

How does study of Market Cycles help in improve Investing?

No one has placed as much importance on the behaviour of the market as legendary investors like Benjamin Graham and Warren Buffett.

Their focus on understanding the nature of the market is the single biggest factor behind their success. This is the most important lesson they can teach us.

The reason behind their curiosity is the volatile nature of the market. You might wonder why almost all the markets follow a cyclical pattern rather than a structural uptrend. Indeed, severe ups and downs follow a certain recurring pattern.



A deeper examination of all the bubbles and market manias of the past reveals a recurring theme without fail. We can examine historic ones, including:

- Tulip Mania of 1634,
- Mississippi company crisis of 1718,
- South Sea Bubble of 1720 and
- The Great Depression of 1929.

We can also look at modern ones, including:

- The 2008 global market meltdown and Subprime Crisis
- Global economic slowdown caused by Coronavirus pandemic

The recurring theme that characterizes them all is a boom and bust cycle.

A Pendulum that Forever Swings

Volatility is the sticky nature of the market, which cannot be undone.

"The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The Intelligent Investor is a realist who sells to optimists and buys from pessimists."

— Jason Zweig

The cyclical nature of the market has never changed, though reasons for optimism and pessimism could be different, and ever changing.

That is precisely the reason that something as simple as "Buying Low" has worked wonderfully across market cycles.

Because of this consistent, recurring swing in markets, it becomes even more important to study market behaviour and market cycles.

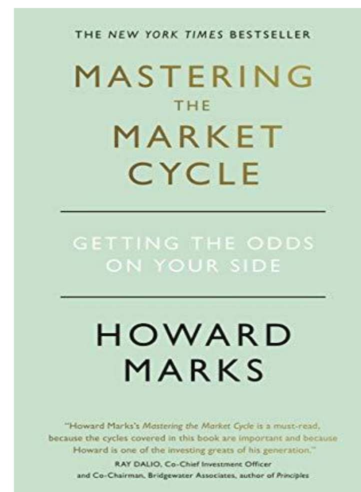
Sir John Templeton *once said:*

> *"The four most dangerous words in investing are: "This time it's different."*

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."

-Peter Lynch

"Most of the great investors I've known over the years have had an exceptional sense for how cycles work in general and where we stand in the current one. That sense permits them to do a superior job of positioning portfolios for what lies ahead. Good cycle timing — combined with an effective investment approach and the involvement of exceptional people — has accounted for the vast bulk of the success of my firm,"



-Howard Marks of Oaktree Capital Management in his famous book Mastering The Market Cycle

"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions."

--Seth Klarman

In markets, it’s never different. Cycles are permanent and recurring in nature and investors who have ignored cycles have done huge damage to themselves and their investments.

> ***Benjamin Graham***, *the father of value investing, believed that the market is your partner in trade. Graham was probably the only guru who dwelt on the behaviour of the market and was able to successfully demonstrate what he believed.*
>
> *An important aspect of his thought was his observation of the cycles of market behaviour, which continues to stand solid as a rock today.*

An Edge to Put us in the Winning Seat

Investing is zero sum game – if one gains, the other must lose. It is thus important to have some advantage of greater knowledge over your competitor.

Investors who have knowledge of what they are doing have an edge over investors who do not know or lack enough knowledge about what they are doing.

"If we have the same information as others, analyze it the same way, reach the same conclusions and implement them the same way, we shouldn't expect that process to result in outperformance,"

-- Howard Marks

As investors we do not know the future and have no ability to predict it. Even if the probability of an event is very high, we can never eliminate failure.

When we accept that we cannot predict the future, the option that remains for us to win the game is to know more than what others know about the possibilities the future can hold.

Understanding of the cycle is thus crucial. It provides an advantage that can put us ahead of others.

If we understand the cycles, then our chances of excelling over our competitors improve. That understanding gives us an edge during events which are likely to unfold in the future.

The late, great economist Merton Miller aptly said "To beat the market, you`ll have to invest serious bucks to dig up information no one else has yet".

In other words, to improve the chances of one's portfolio getting above average returns, one needs to have access to above average information.

> *According to the late, legendary investor **John Templeton**, every market goes through a life cycle, similar to the natural life of living beings.*
>
> *Markets are born, they grow, they mature, and then they die, and the process repeats itself. The successful investor must learn to recognize cycles and assess them.*

This is especially important because the odds of success changes as the position within the cycle changes.

Only if one can combine his data edge with a deep understanding of market cycles can he take appropriate action and expect to do well.

Improve Our Understanding of its Behaviour

Noted wealth advisor Eleanore Szymanski says:

"Understanding market cycles can help you make better investment decisions"

Stock market cycles are something of a mystery. Even if investors know that the market follows a cyclical nature, these questions arise:

Why don't they act in a timely fashion?

Why don't investors exit their portfolios at the cycle peaks and buy more when the market is down?

The reason is simple. Most investors lack an understanding of the cycles and the factors that influence them.

The future holds different possibilities and probabilities. It does not follow a fixed pattern or yield a fixed outcome. It is thus critical to think in terms of probabilities and ranges of outcomes.

We can do this by studying the cycles and improving our understanding of their behaviour.

If we carefully study cycles, we could be in a position to understand how various factors influence them.

The superior investor is the one whose insights into these tendencies give him a sense of where he stands with respect to the cycles. Additionally, he is aware of what should influence his actions.

> The future is uncertain and there is randomness in the behaviour of the market. Our knowledge of cycles and their historical behaviour can help us deal with it profitably.
>
> Of great importance is the fact that the average investor is unaware. They lack understanding of the nature of the cycle. Many of them have not even seen or studied enough cycles.

Therefore, they don't know what influences cycles and what significance this information holds in making prudent investment decision.

That said, if we have more information than our competitor, our outcome should certainly be better than an average investor.

Armed to Deal with Risk

According to Mr. Marks, risk is simply defined as the possibility of things not going your way, leading to a permanent loss of capital.

The market is inherently risky and one must be prepared for both upturns and downturns.

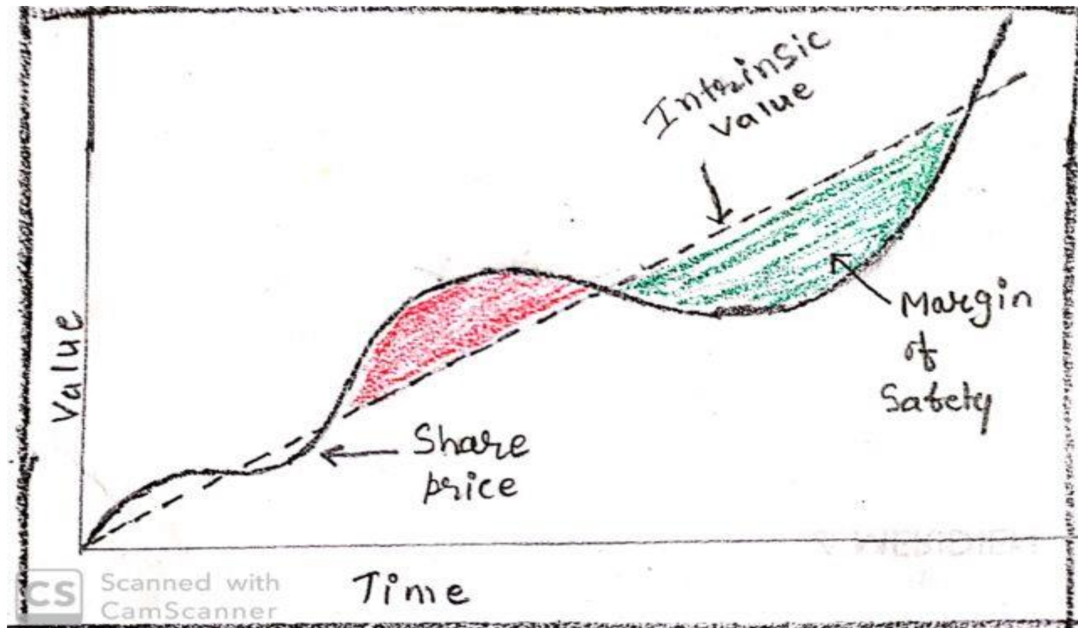
> Benjamin Graham rightly said:
>
> "Successful investing is about managing risk, not avoiding it".

In effect, one should have an opinion and then gauge the likelihood of the opinion coming true.

Some events can be predicted with confidence, while others are somewhat uncertain. Still others are completely unpredictable. The successful investor is always on his toes.

He is consistently prepared to take appropriate actions in response to market cycle variations.

He is the one who invests while keeping a sufficient margin of safety in place to manage the risk and tide over the vagaries of the market.



In simple words, the sensible investor must take note of whether past patterns seem to be repeating.

His experience comes into play in making appropriate judgements, managing risk at relevant stages in a cycle, and then taking action.

Allow us to position

Phillip Fisher, the father of growth investing and legendary investor once said that "The stock market is filled with individuals who know the price of everything, but the value of nothing."

What he was probably referring to is a mistake most investors make. They focus on the stock price of potential investments rather than looking at the value of the firms.

In investing, this is considered to be the biggest mistake and one that is often condemned by many legendary investors.

One must strike the right balance between the price paid and the intrinsic value, and then correctly position their portfolio in the cycle.

"You must buy on the way down. There is far more volume on the way down than on the way back and far less competition among buyers".

-- Seth Klarman

Understanding cycles allows us to focus on the right elements.

If we, as investors, know the cycles and the behaviour of the cycles, then we can maintain a balance between aggressiveness and defensiveness.

All the while, we can constantly evaluate and monitor our portfolios and investments. This is the biggest takeaway: Investors are armed not only to deal with the risk but to act appropriately to take the advantage of a given cycle.

They can allocate capital appropriately both in terms of its amount and timing to be from the cyclical nature of the market.

"If we apply some insight regarding cycles, we can increase our bets and place them on more aggressive investments when the odds are in our favour, and we can take money off the table and increase our defensiveness when the odds are against us,"

--Howard Marks

Such positioning can only be possible if we study the cycles and correctly identify trends pertaining to the characteristics of a given cycle.

Chapter 2

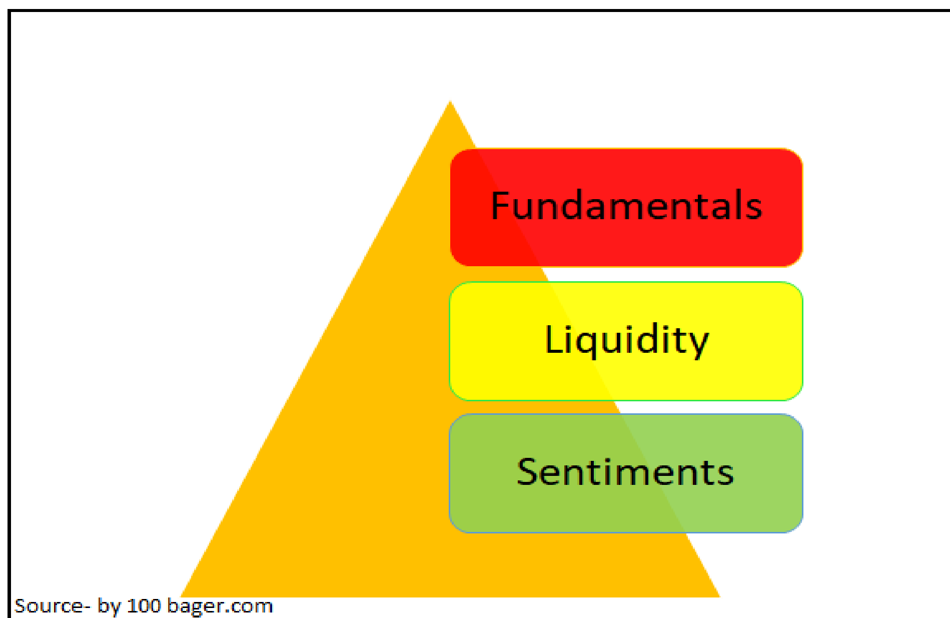
What causes markets to follow a cyclical pattern?

Markets are not typical science. They get influenced by several factors all the time making them difficult to understand. However, market cycles inherently go through these 4 stages: take-off, peak, distribution and fizzle-down.

Traditional investors gauged the market by 3 aspects, fundamentals, sentiments, and liquidity. Even today these helps to understand the factors that influence the market cycle.

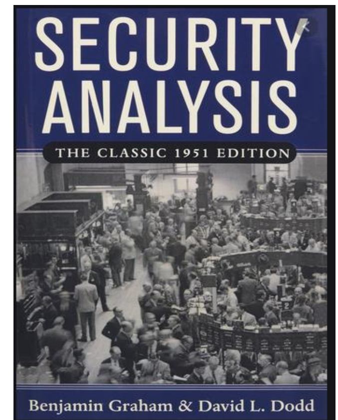
Importantly, most of the factors working in favour or against the market can be put in in these three baskets.

- **Sentiments**
- **Liquidity**
- **Fundamentals**



They are good enough to get a sense of where we are in any given cycle.

Emotions: The most critical part



Emotions literally rule the stock market. Benjamin Graham in his book "Security Analysis" under the chapter 3 described, "Market is not a weighing machine.

It is a voting machine, whereon countless individuals register choices, which are the product partly of reasons partly of emotion."

This crucial discovery by Graham is ranked as the biggest achievement of behavioral finance, in our understanding emotions.

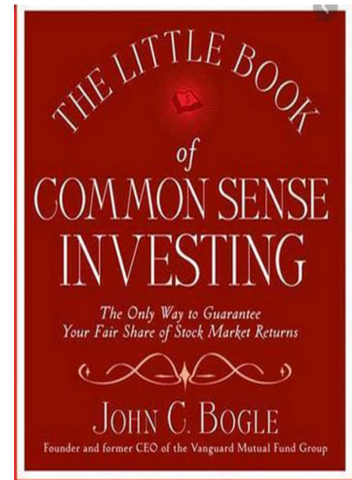
Emotions are important variables. Therefore, play a huge role in manipulating cycles thus making them hard to predict.

Individuals and market as a whole suffer from emotions such as greed and fear.

"The market is a pendulum that forever swing between unsustainable optimism and unjustified pessimism"

-- *Benjamin Graham*

> ***"After more than 55 years in this business, I have absolutely no idea how to forecast these swings in investor emotions," reveals John Bogle, in his most celebrated book "The little Book of Common-Sense Investing"***



Investor's psychology and their behaviour play a huge role in markets.

For instance, just after the end of the WWI in 1918, a new wave lashed in the US, and Europe popularly known as "**Roaring Twenties".**

Economic prosperity boomed with growing industrialisation, flow of capital and opening up of the society. Investors behaviour was as if they were on cocaine or been drunk all day.

Investors bought any stock at any price. The greed in the market spread and irrationality took over the wider market.

This huge craze led to an era of mass consumerism.

> In the decade from 1919 to 1929, the US Dow Jones jumped more than four-fold from a level of 80 to 381. However, when the cycle turned, production declined, unemployment rose, panic set in.
>
> The fear of losing money and other accompanied emotions led to a massive market crash.

The year 1929 marked the onset of *The Great Depression.* The US Dow Index crashed further to a rock bottom level of 41.22 by the end of July 1932.

Sentiment: Lifting all boats.

Fear and greed are the influencing sentiments. Rising prices and positive market sentiments combined with an echo chamber of positive information make people illogically bullish.

> It opens a window of opportunity to both short- and long-term investors, that can help a few businesses thrive.
>
> Similarly, negative market sentiments following a weak economy drive people to become bearish. Increased Interest in Safe haven assets like precious metals, real estate and currencies of US and Switzerland are signs of a bear market.

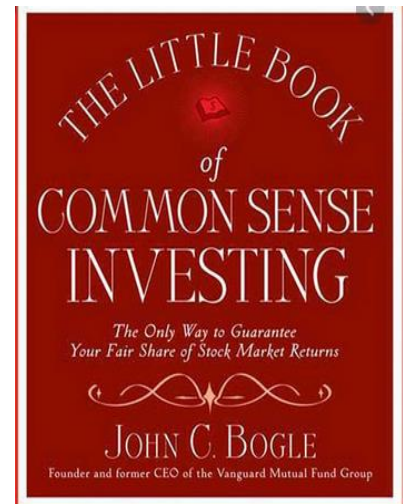
For instance, in the year 2000 market hype and optimism lead to the severe over valuation of several IT companies. Eventually in Oct 2002 markets dramatically came crashing down.

The NASDAQ crashed by as much as 76.81 %. Some companies such as North point communication and global crossing went bankrupt entirely.

Others like Cisco, Intel, and Oracle lost as much as 86% of their value. Companies like micro strategy had their share price fall from $333 to $140 or 62% in a single day.

"We ignore that when the returns on stocks depart materially from the long-term norm, it is rarely because of the economics of investing—the earnings growth and dividend yield of our corporations.

Rather, the reason that annual stock returns are so volatile is largely because of the emotions of investing,"



--John Bogle, in one of his books "The little Book of Common-Sense Investing.

Nobody in life likes to be left behind or miss out on an opportunity. Investors are no different.

When markets are rising, people are discussing the profits they've made and the news is full of stories about how the markets rise.

So most people invest for fear of missing out on what everyone assures them is a great opportunity.

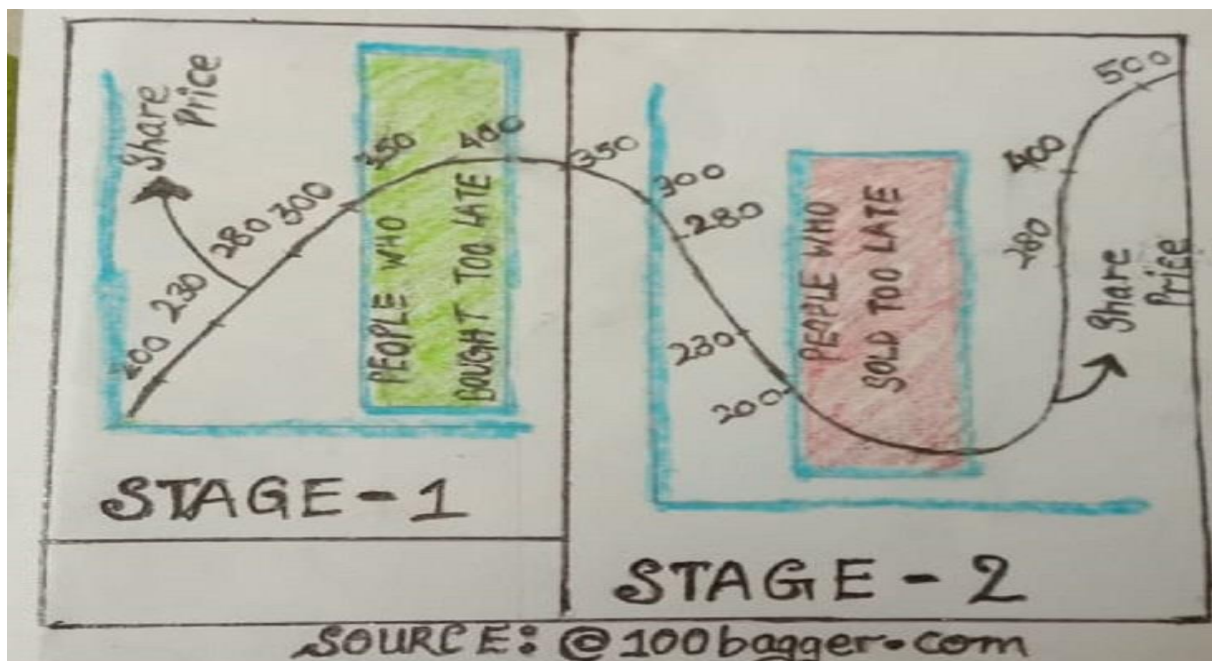
Individuals and market as a whole suffer from emotions such as greed and fear.

> *"Unlike market bottoms where investors are too skeptical, during upswings most people believe too much, worry too little and fail to apply enough skepticism.*
>
> *Since all investors want a good deal – and see the people around them making money so easily – they tend to jump aboard. They want to see the good times roll on, not to pour cold water on the party by questioning what's going on,"*
>
> *--Howard Marks, Memo 2007*

This in turn drives the market even higher. Even some of the smartest people in the world are not immune to this.
In the early 1820's even Sir Isaac Newton invested in the markets. He cashed out with an almost 100% profit in the South Sea company.

The trend continued and swept up a rising tide of emotions. When Sir Isaac Newton invested again, he lost more than his original investment.

He described his experience in saying “I can calculate the motion of heavenly bodies, but not the madness of people”.



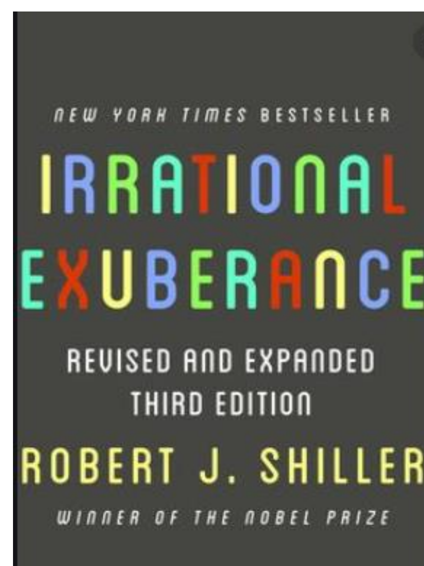
Market Sentiment complimented with fundamental and technical analysis puts traders less at risk of huge losses.

Fundamentals help to understand the underlying value. Technical analysisis performed by checking the past years’ performance of any stock.

The Contagion effects

The author of Irrational Exuberance, Robert Shiller who is well known personality in identifying bubbles and irrational exuberance, once said:

"Irrational exuberance is the psychological basis of a speculative bubble. I define a speculative bubble as a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite



doubts about the real value of an investment, are drawn to it partly through envy of others' successes and partly through a gambler's excitement."

Markus Brunnermeier, an economist at Princeton University, analyzed bubbles all the way back to the Dutch tulip mania in the 17th century.

He concluded, "Crises are most severe when accompanied by a lending boom and high leverage of market players, and when financial institutions themselves are participating in the buying frenzy.

Economic factors

Among other fundamental reasons, economic factors play a major role in the performance of a corporation. An improvement in economic fundamentals usually precipitates the first step of a cycle.

For instance, in the build up to the 2008 peak, the Sensex[1] made a 7-fold gain from the levels of 2,900 in 2003 to about 21,000.

India's GDP in that period grew from a mere 4% in fiscal year 2003 to 9.6% by the end of fiscal year 2007.

	2003	2005	2007	2008	2009
Sensex	2900	7500	15000	21000	8200
Indias GDP Growth (%)	3.73	8.1	9.7	10.2	6.70%
Investment growth	-0.4%	24.0%	13.8%	16.8%	3.5%
Corporate profit to GDP ratio (%)	2.8	3.9	4.9	5.5	4.3

Source: 100bagger.com

At the low point of the Sensex in the year 2003, investment growth was negative at -0.4%.

In the later years, growth jumped to 24% by fiscal year 2005 and further surged by 16.2% by the end of fiscal year 2008.

Higher GDP and investment demand had a profound impact on corporate profits and earnings leading to exponential growth in share prices.

Economic growth and corporate earnings play major roles.

Certain economic events, or a combination of economic events, could derive from the collective efforts of the central banks and the government. These could sometimes accidentally or deliberately push an economy to the extreme.

> For instance, in the US, during the boom period of 1920 to 1929 – a period characterized by economic prosperity and roaring twenties -- the US GDP expanded by a huge 40% from $580 billion to $820 billion, driving markets to their highest levels.

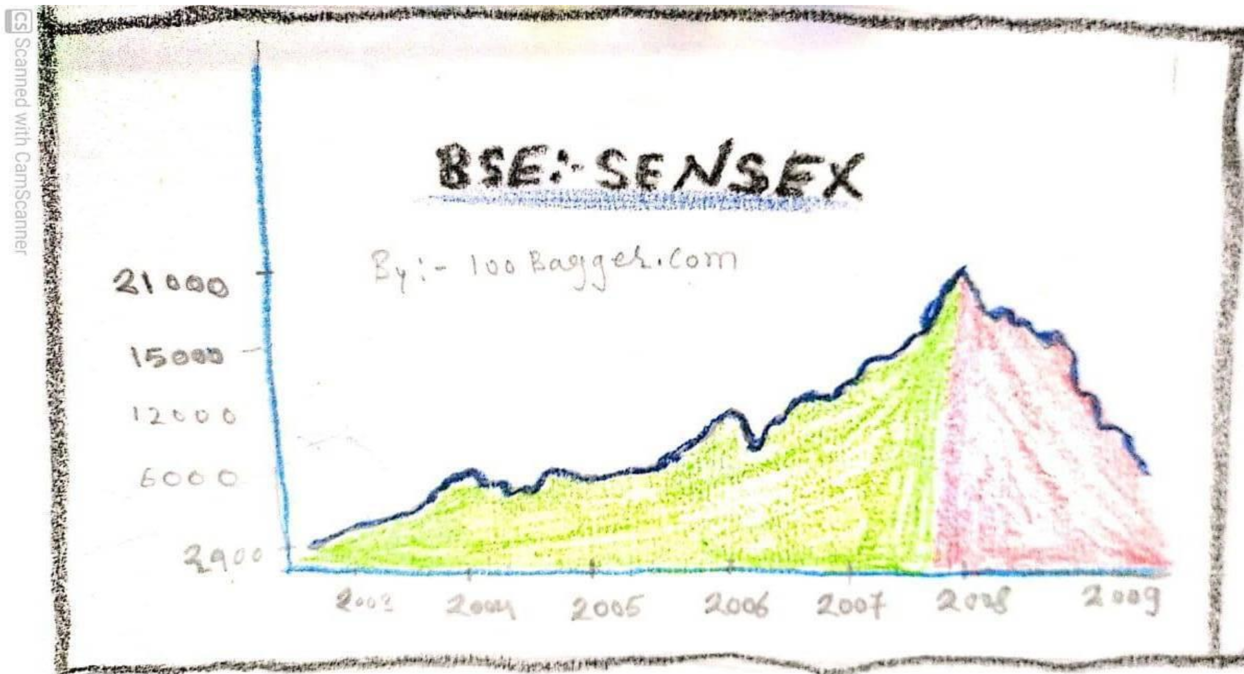
While prosperity is good and healthy for the stock market, extreme prosperity, hyper growth or hyper activity in an economy could also plough seeds for a down cycle or a recession.

This may not be desirable from the stock market's point of view.

For instance, India's GDP growth slipped from 9.6% in fiscal year 2008 to a low of 6.7% in fiscal year 2009. During this

period, corporate profits to GDP fell from 5.5% in 2008 to 4.3% by 2009.

The Sensex tumbled from a high of around 21000 to hit a bottom at around 8900 levels, a correction of almost 60% within a short period of time.



Earnings and Valuations

Economy and economic activity may not be the only factors. Usually, when the tide is up and the economy is doing well corporations start to report strong earnings growth.

As a result of economic factors, such as higher demand, corporate profitability at an aggregate level begins to look better.

The market and investors begin not only to factor in current earning, but also to place a lot more weight on expected earnings.

> In the fiscal year 2006, Sensex EPS grew by 22% and further by 31% in fiscal year 2007 to Rs 718. The market was expecting similar growth for the next two years, with the consensus expecting around Rs 1000 EPS by the end of fiscal year 2009.
>
> A combination of high growth expectations, certainty about earnings, high liquidity and sentiments led to PE (price to earnings) expansion.

Around that period, based on historical earnings, the Sensex was at its peak of about 21000 and was trading at 30 times.

However, investors did not mind paying more, considering the expectation of higher growth.

Someone who was buying at that time, thought that even at 30 times, the Sensex was cheap or reasonably priced considering it was only about 20 times its 2009 earnings expected at around Rs 1000 a share.

Unfortunately, 2009 did not turn out to be what was expected. Because of the global economic slump, Sensex EPS fell by 4% to Rs 820 a share against initial expectations of about Rs 1000 a share.

	2003	2005	2007	2008	2009
Sensex	2900	7500	15000	21000	8200
Sensex EPS	272	450	718	833	820
Sensex EPS Expectation	NA	NA	NA	860	1033
Sensex EPS Growth Expectation	NA	NA	NA	25%	20%
Sensex PE (x)	10.7	16.7	20.9	25.2	10.0
Forward PE (x)				24.4	20.3

Source: 100bagger.com

As we discussed, earnings and valuation play an important role in market cycles. Higher-than-expected earnings boost valuations.

When investors see this increase, they get excited. Emotions fuel their investment decisions and thus further driving up price.

Availability of Capital and Risk Appetite

Availability of capital and risk appetite is like fuel on the fire. At times, people can take extremely risky decisions to try and boost profits.

They may even go so far as to mortgage their homes and vehicles. They further leverage themselves without realizing that even a movement of one or two percent is enough to completely wipe out an overleveraged investor's portfolio.

> In 1998, the US markets tumbled by more than 20%. One of the largest hedge funds in that period was Long Term Capital Management.
>
> They relied primarily on leveraged trades. This position brought the fund to near bankruptcy. By August 1998, the fund lost close to 50% of its invested capital. Had it not been bailed out, the US economy could have faced severe consequences.

Too much availability of capital at low rates is often associated with the speculative trades.

> When liquidity is high and cheaply available, markets are influenced by the flow. Data suggests that by the end of 1929, close to $8.5 billion of borrowed money was in circulation, which was more than the company in circulation in that year.

> More often than not, people are motivated to invest when they have the means to do so.

The presence of excess capital can often influence them to rush into unwise investments. The 2008 sub-prime mortgage crisis is a great example of this.

Banks with excess holdings gave out loans freely. These loans were subsequently bundled and sold and resold without due consideration.

This was a result to the excess of capital lying around. Eventually, due to the inability of debtors to repay their debts, the bubble burst and the markets crashed globally.

The Lollapalooza effect

When many things converge at a given point, the magnitude of impact is great.

While emotions play a critical role, every boom and bust cycle is the result of several factors working together.

This is known as the Lollapalooza Effect.

This occurs when multiple factors combine and reinforce each other to produce an outcome.

For instance, during the Global Market Bubble of 2008, here are the many factors that created a Lollapalooza effect that drove the market into the bubble zone:

- *Availability of cheap capital*
- *Low interest rates*
- *A strong run up in commodity prices*
- *An asset price bubble that made people rich overnight*
- *Strongest growth in the global GDP*
- *Relatively peaceful geopolitical environment*
- *Increasing financial leverage*
- *Investors' risk appetite*

Charlie Munger beautifully describe the situation in his words saying,

"An investment decision in the common stock of a company frequently involves a whole lot of factors interacting … the one thing that causes the most trouble is when you combine a bunch of these together, you get this lollapalooza effect"

This is an important point to understand the extremes of cycles. Why certain market cycles get pushed to the extremes, both in downward and the upward trend. One of the most respected investment strategist, Michael Mauboussin, released an interesting paper "Procyclicality and Its Extremes". His findings shed some light on this vital aspect.

"The history of markets teaches us that we have financial cycles. At some times, asset prices reflect a great deal of optimism. Think of the dot-com stocks in the late 1990s or the housing market from 2002-2007. At other times, prices reflect fear"

--Michael Mauboussin

He further elaborated:

> *"In economics, procyclical variables move in the same direction as the overall economy: Consumers, businesses, and investors are bold when economic conditions appear strong and timid in the wake of weakness.*
>
> *Procyclical behaviour need not be reckless or irrational. Some procyclical behaviour is warranted because there is more opportunity when the economy is strong than when it is weak"*

From his research paper:

Procyclical feedback loops commonly start with fundamental economic strength that becomes virtuously self-reinforcing. For example, an increase in consumer demand leads to greater business investment, which leads to higher employment, which spurs additional demand. The process also works in the opposite direction.

Whether up or down, a trend in fundamentals can morph into a feedback loop that pushes asset prices to an extreme. While it is difficult to isolate the exact cause of a procyclical extreme, we can offer a taxonomy that captures much of the behaviour we observe. The boundaries between these categories are blurred, but they reflect most of what we see in markets.

The important lesson that his study offers here is to understand the magnitude and to question whether the fluctuation or extreme cyclicality is justified in the context of fundamentals.

Mauboussin puts it this way. “In other words, in an upswing, we should ask whether asset prices reflect what Alan Greenspan called “irrational exuberance.” And in a downswing, we should ask whether prices reflect “irrational despair.”

Chapter 3

Understanding the Nature of a Cycle

To understand the nature of cycles, one will have to understand the market. The best way to get the grip is to simply heed to the advice of Benjamin Graham and Warren Buffett.

The best explanation of the market and its mood is provided by Benjamin Graham, who invented Mr. Market an analogy that he and his disciples used to describe the market.

"Mr. Market is like a drunken psycho. Some days he gets very enthused, some days he gets very depressed. And when he gets really enthused you sell to him, and if he gets depressed, you buy from him. There's no moral taint attached to that."

-- Warren Buffett

Getting acquainted with the market, Benjamin Graham asked individuals to visualise Mr. Market as one of your partners in business.

> A partner who frequently offers to sell his shares or buy yours. He is often a maniac, depressive, and pessimistic while other times optimistic, greedy, exuberant, and wildly valuing businesses.

Market cycles result from market behaviour and market mood. If we understand the nature of the market, we will understand the nature of cycle. This is an important chapter enabling us to take the right course of action.

In a nutshell, a few important traits or characters of the market noted from the book "Security Analysis" and “Intelligent Investor” by Benjamin Graham are worth noting down.

Mr. Market is

- Emotional and moody.
- Often termed as irrational.
- He who trades or offer frequent transactions.
- Whom investors have an option to trade with or completely ignore.
- There to serve you.
- Someone who acts like a voting machine in the short run, but in the long run he is a weighing machine.
- You as investor have a choice to transact, buy low, and sell high.
- Not efficient most of the time.

What does a Market Cycle look like?

Market cycles can be viewed as a combination of a straight lines from lower left to upper right and another line which moves up and down around it. Over the long term the cycles tend to move upward in general, though in a non-linear fashion.

> ***"The extraordinary thing about the securities market if you judge it over a long period of years, is the fact that it does not go off on tangents permanently, but it remains in continuous orbit"***

–Benjamin Graham

However, there are also some periods of "outlier" events causing the cycles to fluctuate wildly from the straight path causing periods of boom and bust.

For instance, the Dow Jones Industrial Index had lost 11% on a single day during the peak of 2008 recession. And it also gained 10% on a single day on reports of a vaccine to Corona Virus Pandemic during March 2020.

Nature of Cycles

Cycle events should not be viewed in silos as one cycle being followed by the next. But it should be viewed as one cycle causing the next.

"The stock market is the story of cycles and of the human behaviour that is responsible for overreactions in both directions"

–Seth Klarman

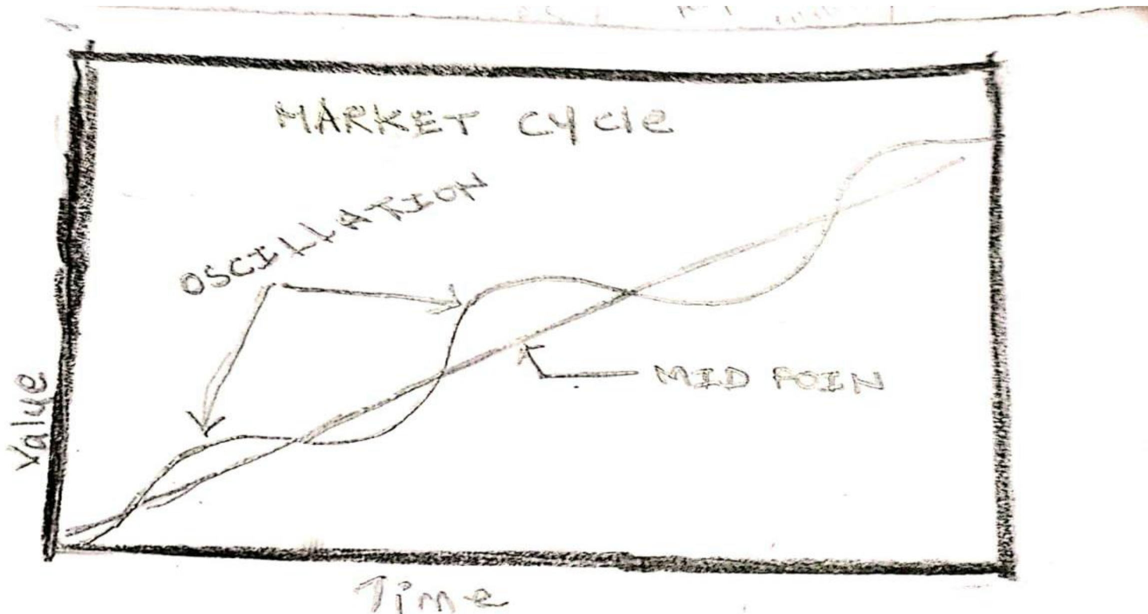
However, over time the occurrence of a cycle must be viewed as a sort of chain reaction, one which is caused by events that happened before.

Since the cycles last for a fairly long time, sometimes even seasoned investors are not able to view it correctly as they have not seen enough cycles to comprehend.

Howard Marks explained this phenomenon with an excellent analogy in his 2009 memo,

> ***"The Long View". "There's an old story about a group of blind men walking down the road in India who come upon an elephant. Each one touches a different part of the elephant—the trunk, the leg, the tail or the ear—and comes up with a different explanation of what he'd encountered based on the small part to which he was exposed.***
>
> ***We are those blind men. Even if we have a good understanding of the events we witness, we don't easily gain the overall view needed to put them together. Up to the time we see the whole in action, our knowledge is limited to the parts we've touched."***

Cycles oscillate around the mid-point



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Cycles in general tend to oscillate around a mid-point and swing back and forth from there.

The mid-point is extremely important as it constitutes a normal or a secular trend and is also the mean of the cycles.

The farther the movement of the cycles from the mid-point, the farther is the aberration. These generally represents period of extreme boom or recessions.

"The midpoint of a cycle is generally thought of as the secular trend, norm, mean, average or "happy medium".

–Howard Marks

"Stock market corrections, although painful at the time, are actually a very healthy part of the whole mechanism, because there are always speculative excesses that develop, particularly during the long bull market".

–Ron Chernow

Over a period of time, these extreme movements tend to fall back towards the cycle mid-point. Apart from aberrations, the cycles tend to oscillate close to the mean.

As cycles move in extremes a kind of force is developed which brings them back towards the mid-point. These cycles could be different.

Every time they evolve, their duration, timing, magnitude, the force of the swing and of course the reasons for the swing could be different every time, but the underlying theme remains same.

They tend to oscillate back and forth from the mid-point. They may not have similarity, because they keep on evolving and progressing. They do not settle at any of the point.

Cycles do not have a starting or end point

A cycle passes through various phases like recovery from a low towards the mean point, attainment of a high, downward correction towards the mean, continuation of the cycle past the midpoint to reach a new low and then the cycle tends to repeat itself.

> *"People often ask me "what caused the cycle to begin?" or "are we close to the end of the cycle?" I consider these improper questions, since cycles neither begin nor end. Better questions might be: "what caused the current up-leg to begin?" or "how far have we gone since the beginning of the up-cycle?" or "are we close to the end of the down leg"*
>
> *–Howard Marks*

While any of these points can be viewed as the start of the cycle, end of the cycle or any point in between, it is very difficult to pin-point the exact start and end of the cycle.

Over a period of time, the cycles are self-correcting and tend to move towards the cycle mid-point or the norm.

The more they move away from the midpoint, the more they become violent and create havoc. Like a law of gravity, the oscillations from the extremes could be powerful and force the cycles to be violent.

Thus, the midpoint or the mean of a cycle is an important point of any cycle.

> The great investor, Lt. John Bogle, spoke in an almost prophetic fashion "The Boom and the Bust were normal- just two more swings in stock returns over the past century. Reversion to the mean is the iron rule of the financial markets".

It couldn`t have been summed up better. Regardless of how far cycles deviate away from the mid-point, their natural trend is always to move towards it.

Chapter 4

Can we Time a Cycle?

The future is always unpredictable. Those who try to understand or indulge in prediction make a lot of assumptions, which again make it even weaker.

Every precise method and even intelligent people have failed to predict the future because it is not a perfect science. Every intelligent investor from Charlie Munger to Warren Buffett have spoken about its unpredictable nature.

"I can't time stocks. I don't know anybody else who can either."

–Warren Buffett

"Those who have knowledge don't predict; those who predict don't have knowledge."

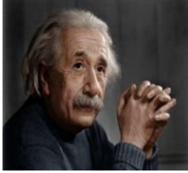
–Lao Tzu

"No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future."

–Ian E. Wilson (former Chairman of GE)

"People can foresee the future only when it coincides with their own wishes, and the most grossly obvious facts can be ignored when they are unwelcome."

–George Orwell



"I never think of the future–it comes soon enough."

–Albert Einstein

"Forecasts usually tell us more of the forecaster than of the future."

–

--Warren Buffett

"Forecasts create the mirage that the future is knowable."

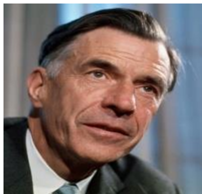
–Peter Bernstein

"The future you shall know when it has come; before then forget it."

–Aeschylus

"Thousands of experts study overbought indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply…and they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."

--Peter Lynch



"The function of economic forecasting is to make astrology look respectable."

--John Kenneth Galbraith

"The idea that a bell rings to signal when to get into or out of the stock market is simply not credible. After nearly fifty years in this business, I don't know anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has."

--Jack Bogle

Forecasting stock market cycles and stock markets is very tricky. Hence it's a niche skill that only few people have.

Most stock market predictions are results of randomness and luck.

Howard Marks illustrates what makes prediction and forecasting difficult in his memo "Uncertainty". It was published in May 2020, a time when the global markets were grappling with the Covid-19 pandemic.

Multiple factors working at once: Many factors influence markets and market cycles in varying proportion and at different times. Correct prediction is hard due to several forces working in different proportions at any point in time.

> ***For investors, the future is determined by thousands of factors, such as the internal workings of economies, the participants' psyches, exogenous events, governmental action, weather and other forms of randomness. Thus, the problem is enormously multi-variate,"***

-- Howard Marks

Element of randomness: Unlike our expectations of a similar pattern, stock market factors are random in nature. They do not follow a pre-defined trend because of the randomness in sequence, proportion, timing and location.

Howard Marks further quotes, "No one can succeed in predicting things that are heavily influenced by randomness and otherwise inconsistent".

Forecasting is not genuine science: In subjects like perfect science or accounting one can derive a computed result.

The same does not hold good in prediction of markets and stock market cycles. The factors that influence these cycles are economics, business and human behavior.

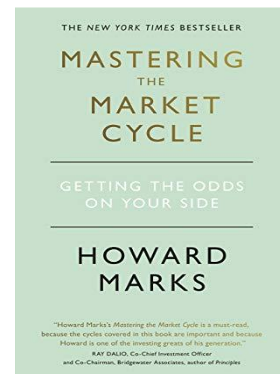
They cannot be calculated and understood precisely, leading to uncertainty. Unreliable inferences: The other problem is unreliability of history and previous data.

Investors often look at historical data and historical perspective to arrive at a conclusion. Drawing inferences from the past almost always results in erroneous predictions.

If not predictable, how can we gain from the study of Market Cycles?

The best thing we can do is, position ourselves relative to the market cycle instead of trying to predict the future. Research shows that most forecasters are no more accurate than predicting result of a coin flip, and often worse.

> ***In his celebrated book, "Mastering the Market Cycle," Howard Marks clarifies, "As I've made clear, I don't believe in forecasting.***



Very few people can know enough about what the future holds for it to add to their returns, and the record of most forecasters—in terms of both predicting events better than others and having better investment performance than others as a result—is quite lackluster.

A few people become famous in each period for singular, spectacular successes, but usually their next correct forecast doesn't come for many years."

Howard Marks suggests because of the inability to see the future; the best thing investors can do is to know where they are in the current cycle.

We may not know where we may end up, but we can know where we are in the cycle. And at this point, dealing with any cycle starts making sense. It' s a better approach compared to forecasting and predicting how and when the cycle will unfold.

We cannot predict future, but we can prepare. Howard Marks in his earlier memo published in the year 2001 titled "You cannot predict. You can prepare," asks, "At the first glance that seems like an oxymoron.

How can we prepare for something that we cannot predict?" However, in the same memo he suggests

"We can do so by recognizing that they inevitably will occur, and by making our portfolios more cautious when economic developments and investor behavior render

markets more vulnerable to damage from untoward events."

And if the odds are in your favour, these are the best times to act.

In his Memo titled "Uncertainty II" dated 28th May 2020, he further quotes "Many years ago, my friend Ric Kayne pointed out that "95% of all the financial history happens within two standard deviations of normal, and everything interesting happens outside two standard deviations."

Arguably, bubbles and crashes fall outside of the two standard deviations, but those are the events that create and eliminate greatest fortunes"

In another memo titled "Calibrating," dated April 14th 2020, Howard Marks defines "Investing as the act of positioning capital, so as to profit from future developments."

- He further mentions that "The challenge is presented by the fact that there's no such thing as knowing what future developments will be. This is the paradox that investors deal with."

Techniques to Predict the Future

One way to predict probable future occurrences is to extrapolate past patterns. Given a sufficiently long interval of time, the market patterns tend to replicate cycles.

Howard Marks, in his observations of Marc Lipsitch, a Harvard Epidemiologist, tinkered them to the world of investing. In his memo, "Knowledge of The Future" dated April 14, 2020, he details:

"To follow Lipsitch's analysis, in our world of investing:

- there are few if any facts regarding the future,
- the vast majority of our theorizing about the future consists of extrapolating from past patterns, and
- a lot of that extrapolation – and just about all the rest of our conclusions – consists of what Lipsitch calls opinion or speculation and what I call guesswork."

Marks further points, “We use extrapolation from the past as the best way to deal with the future. If not for the ability to research past patterns and apply them to decisions regarding the future, we’d have to reach a new conclusion every day about every future possibility.

So, for example, in investing we study typical past cycles, the exceptions from the norm, and details like the up-and-down pattern that’s part of most rallies.

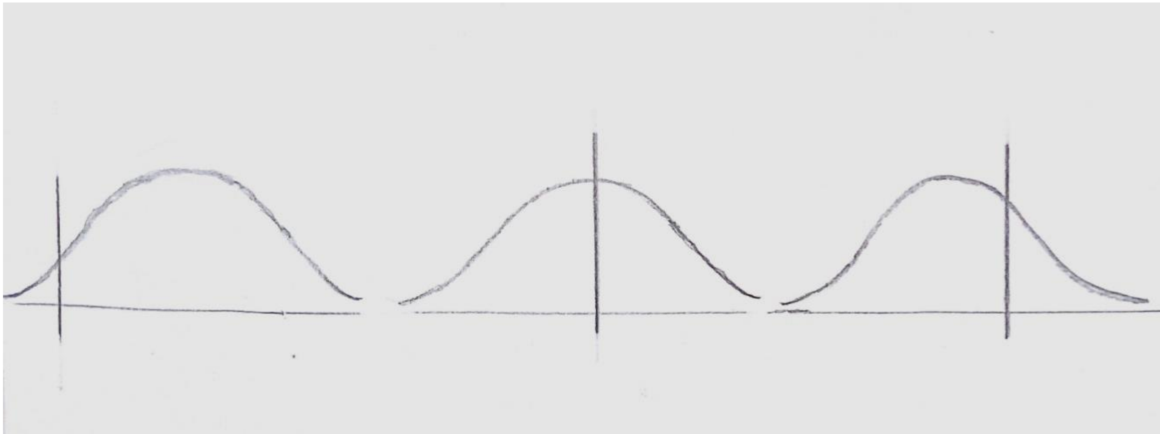
But blind faith in the relevance of past patterns makes no more sense than completely ignoring them. There has to be good reason to believe the past can be extrapolated to the future; as Lipsitch says, it has to be informed extrapolation.”

Know-how on the cycle patterns helps predict a probable future occurrence. Here too we cannot be certain about future events, but we can arrive at a probable estimate of future occurrence after studying the past cycles.

Hence the focus is on informed extrapolation, and not on blind prediction on where the cycle will be heading.

Chapter 5

Understanding where we are in a Cycle



Once we understand the cycle's actual nature and the influencing factors, we will be capable enough to recognize where we are in the cycle. This critical information arms us with the knowledge to take appropriate actions.

To mitigate or manage risks or taking advantage of the cycle, we need to figure out where we are in the cycle and this chapter is all about this.

Imagine vertical arrows drawn on a bell curve to understand our position in a cycle. If we are at the

beginning of the bell curve, we ride up to the peak of the curve and have the maximum chances of gains.

If we start at the peak of the bell curve and ride through the downward spiral in the cycle, we have the maximum chances of losing.

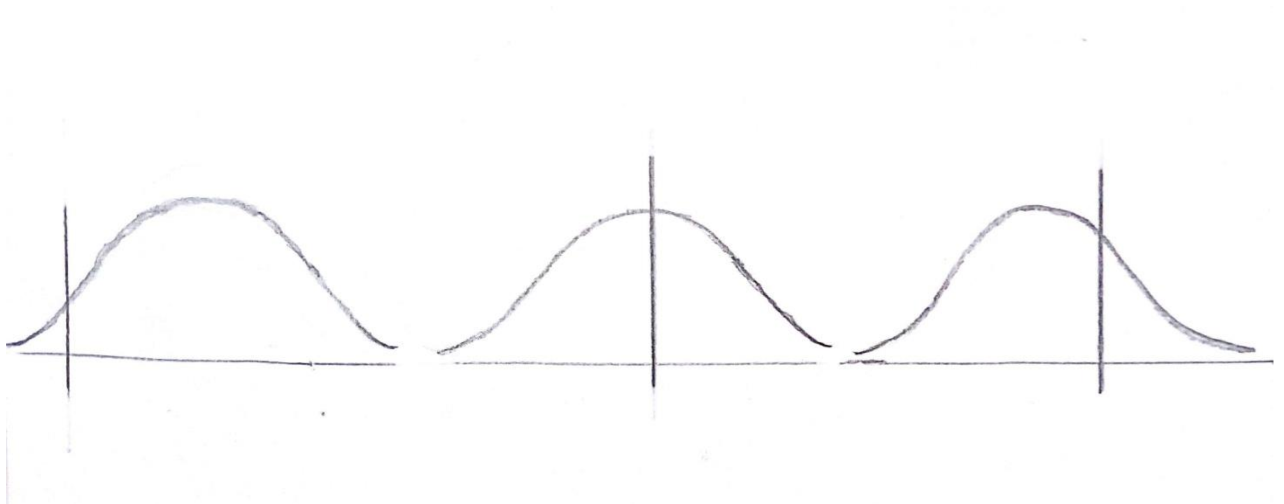
But how do we know our relative position in the cycle? A successful investor, John Templeton once said that “Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria”.

While that was a psychological expression of the cycles, there are enough cues for everyone to see one’s position in the cycle.

“Whenever the pendulum is near either extreme, it is inevitable for it to move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back,”
–Howard Marks

At any point in a cycle, factors as discussed above—fundamentals, sentiments, liquidity—form the core of the assessment. We must view most of the cues we get or the indicators that help to determine our spot in a cycle through the lenses of these factors.

Let's look at the important stages of a cycle



Start of the Cycle

A prime example of this was in 2003, at the start of the bull-run. The Sensex was trading at its historical low, hitting the bottom at 2924 levels.

The economy and earnings hit a low, and the sentiments were at their lowest as investors did not want to own equity. All these reasons led to a slowdown.

	2003	2005	2007	2008	2009
Sensex	2900	7500	15000	21000	8200
Indias GDP Growth (%)	3.73	8.1	9.7	10.2	6.70%
Investment growth	-0.4%	24.0%	13.8%	16.8%	3.5%
Corporate profit to GDP ratio (%)	2.8	3.9	4.9	5.5	4.3

Source: 100bagger.com

India’s GDP, which grew at 8.5% in 1999, fell to hit a bottom of mere 4% growth in the fiscal 2003. In this period the investment growth was in negative and wholesale inflation averaged at 3 to 4%.

The Sensex EPS had fallen from 280 in the year 2000 to 236 by the end of the year 2002, a level only seen in 1996.

Most cycles follow a similar trend where, at the bottom of the cycle or the beginning of the next cycle, fundamentals take a beating or deteriorate.

A down cycle in the economy and earnings along with the low valuations make for the perfect pitch or the time when the markets form their bottom. This point also marks the beginning of the new cycle.

In the year 2000 around the global tech bubble, the Sensex was trading at 20 times its earnings. It then fell to 2900 levels in 2003, hitting a valuation of about 11 times its earnings.

	2003	2005	2007	2008	2009
Sensex	2900	7500	15000	21000	8200
Sensex EPS	272	450	718	833	820
Sensex EPS Expectation	NA	NA	NA	860	1033
Sensex EPS Growth Expectation	NA	NA	NA	25%	20%
Sensex PE (x)	10.7	16.7	20.9	25.2	10.0
Forward PE (x)				24.4	20.3

Source: 100bagger.com

During the global financial crisis and economic slowdown in the year 2008-09, the Sensex fell from about 21000 to around 8900 levels. In that period, the Sensex valuations also took a hit and drifted lower from 25 times at the peak to about 11 times at the bottom of the cycle.

Typically, when a cycle starts, sentiments will be low. Investors will doubt or be fearful if they should get in. Liquidity evaporates. Only a few people show interest and very few trades happen.

Fundamentals and most of the indicators like earnings, corporate profitability, economy and most important valuations are likely to be at their lowest point.

Peak of the Cycle

Valuations and fundamentals play a key role in determining where we are in the cycle. The 2003 cycle lasted for approximately 246 weeks.

The Price-to-Earnings (P/E) ratios and Price-to Book(P/B) values continued to scale. In the year 2006 P/E ratio for the index crossed 22, and P/B value ratio crossed over 4 times.

It is a common phenomenon that at the peak of the cycle, the distribution "curve of returns" moves leftwards.

At this extreme, the odds are against you, the chances of profit are low and the risks are high. In 2008, at the peak of the cycle, the Sensex had hit 20873 points with a P/B ratio value of over 6.7 and a P/E ratio of 27.5 towards the tail end.

This is when equity valuations crash and this cycle ends, to pave the way for the next one. Indian economy was growing at its best when it was at the peak of the market.

In the year 2007, India's GDP recorded a 9.8% growth. From the bottom at 2003, the Sensex earnings compounded at 24% to the peak of the market in 2008.

Howard Marks, in his 2001 memo, "You Can't Predict. You Can Prepare", writes about these forces, particularly the sentiments that investors go through at the peak of the cycle.

He writes:

"For decades – literally – I've been lugging around what I thought was a particularly apt enumeration of the three stages of a bull market:

- *the first, when a few forward-looking people begin to believe things will get better,*
- *the second, when most investors realize improvement is actually underway, and*
- *the third, when everyone concludes everything will get better forever."*

Influencing Factors seen at the peak of the Cycle.

- Positive news and environment.
- Consensus upbeat about the earnings.
- Decline in skepticism.
- Absence of risk aversion.
- Excessive flow of credit and ample liquidity.
- And general positive investor sentiments.

Bottom of the Cycle

Again a deep look into sentiments, liquidity and fundamentals can tell us more about a falling trend in a cycle.

For instance, when the Sensex tumbled from about 21000 in January 2008 to the lows of about 8000 in early 2009, India's GDP had crashed to 6.7% by fiscal 2009 as against 10.2% in fiscal 2008.

Howard Marks, in his 2001 memo, writes about the depressed cycles and gives us few tips worth noting.

He writes:

> *"Why would anyone waste time trying for a better description? This one says it all. Stocks are cheapest when everything looks grim. The depressing outlook keeps them there, and only a few astute and daring bargain hunters are willing to take new positions. Maybe their buying attracts some attention, or maybe the outlook turns a little less depressing, but for one reason or another, the market starts moving up.*

> *After a while, the outlook seems a little less poor. People begin to appreciate that improvement is taking place, and it requires less imagination to be a buyer.*
>
> *Of course, with the economy and market off the critical list, they pay prices that are more reflective of stocks' fair values.*
>
> *And eventually, giddiness sets in. Cheered by the improvement in economic and corporate results, people become willing to extrapolate it.*

> *The masses become excited (and envious) about the profits made by investors who were early, and they want in. And they ignore the cyclical nature of things and conclude that the gains will go on forever.*
>
> *That's why I love the old adage "What the wise man does in the beginning, the fool does in the end." Most importantly, in the late stages of the great bull markets, people become willing to pay prices for stocks that assume the good times will go on to infinitum."*

Factors that determine the Bottom of the Market Cycle

In another outstanding memo published in March 2020, he further elaborates about these conditions.

Here is his take about the bottom of the market cycle:

- ★ *"The bottom" is the day before the recovery begins. Thus it's absolutely impossible to know when the bottom has been reached . . . ever. Oaktree explicitly rejects the notion of waiting for the bottom; we buy when we can access value cheap.*
- ★ *Even though there's no way to say the bottom is at hand, the conditions that make bargains available certainly are materializing.*
- ★ *The more you want to garner potential gains and don't mind mark-to-market losses, the more you should invest here.*
- ★ *On the other hand, the more you care about protecting against interim markdowns and are able to live with missing opportunities for profit, the less you should invest.*

But is there really an argument for not investing at all? In my opinion, the fact that we're not necessarily at "the bottom" isn't such an argument.

As Howard Marks said, we cannot predict what happens. Questions whether the market has bottomed or peaked are not relevant.

Any precise tool or science cannot gauge them by any degree. What is relevant is, the conditions and ingredients of such cycles.

We have now discussed many stages of a market cycle and how to know our position in a cycle. One key aspect of this discussion is, these are all mere indications.

In no way they suggest or call for the bottom or peak of the cycle. Instead of getting into the predictions and forecasting, the best an investor can do is to look at them as mere conditions.

A cycle at the different stages of its composition or evolution could be different in magnitude, timing, duration and in no manner signal their future behavior.

They are merely conditions of how a cycle will shape up. Thus we should treat them as a reflection of those conditions rather than a firm indication of its future direction.

Chapter 6

How to position oneself and benefit from Market Cycles?

Finally, everything boils down to finding answers to the BIG questions. How do we position ourselves in a cycle and get major benefits? Or how do we apply what we know about typical market cycles and benefit from them?

In this chapter, you'll discover the important answers to questions like these. Let's address the most critical and important aspect of our study about market cycles.

How to deal with an unknown future?

If we could foresee the future, we would exactly position our investment and trade in such a way that benefits us the most. But in reality, no one knows what the future holds. Then how can we position ourselves favorably in a cycle?

Thankfully, there is a solution to this dilemma. To rightly position ourselves in a cycle, the first and most important task is to think "right" about the future. How?

Howard Marks in his celebrated book "Market Cycle" clearly explains what it means:

> *"In theory we could know exactly how to position our portfolios to avoid loss and garner maximum gains. But in life and in investing, since there can be many different outcomes, uncertainty and risk are inescapable. As a consequence of the above, the future should be viewed not as a single fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and—hopefully on the basis of insight into their respective likelihoods—as a probability distribution. Probability distributions reflect one's view of tendencies.*

Investors—or anyone hoping to deal successfully with the future—have to form probability distributions, either explicitly or informally. If it's done well, those probabilities will be helpful in determining one's proper course of action.

Howard Marks explains:

But it's still essential to bear in mind that even if we know the probabilities, that doesn't mean we know what's going to happen.

In other words, while superior investors—like everyone else—don't know exactly what the future holds, they do have an above-average understanding of future tendencies.

As an aside, I want to add a thought here. Most people think the way to deal with the future is by formulating an opinion as to what's going to happen, perhaps via a probability distribution.

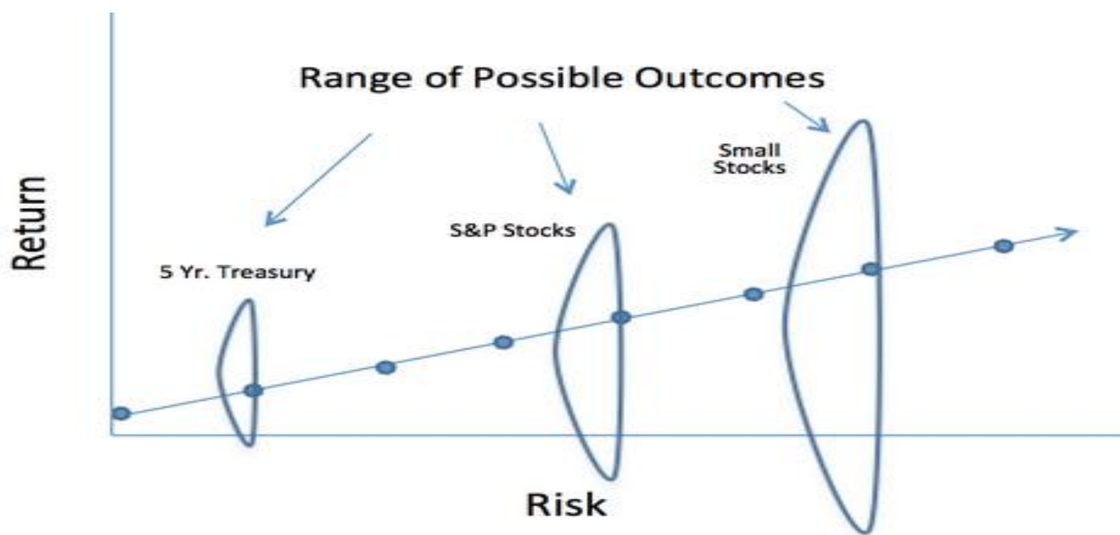
I think there are actually two requirements, not one. In addition to an opinion regarding what's going to happen, people should have a view on the likelihood that their opinion will prove correct.

Some events can be predicted with substantial confidence (e.g., will a given investment grade bond pay the interest it promises?), some are uncertain (will Amazon still be the leader in online retailing in ten years?) and some are entirely unpredictable (will the stock market go up or down next month?)

It's my point here that not all predictions should be treated as equally likely to be correct, and thus they shouldn't be relied on equally. I don't think most people are as aware of this as they should be."

According to Howard Marks, the primary method of positioning ourselves involves a good understanding of the current condition of the cycle.

The next important task is to think about the future in terms of the possibilities and probabilities and not as one set-outcome. It is dangerous to allow one's gut feeling or emotions to take over and expect something unpredictable to happen.



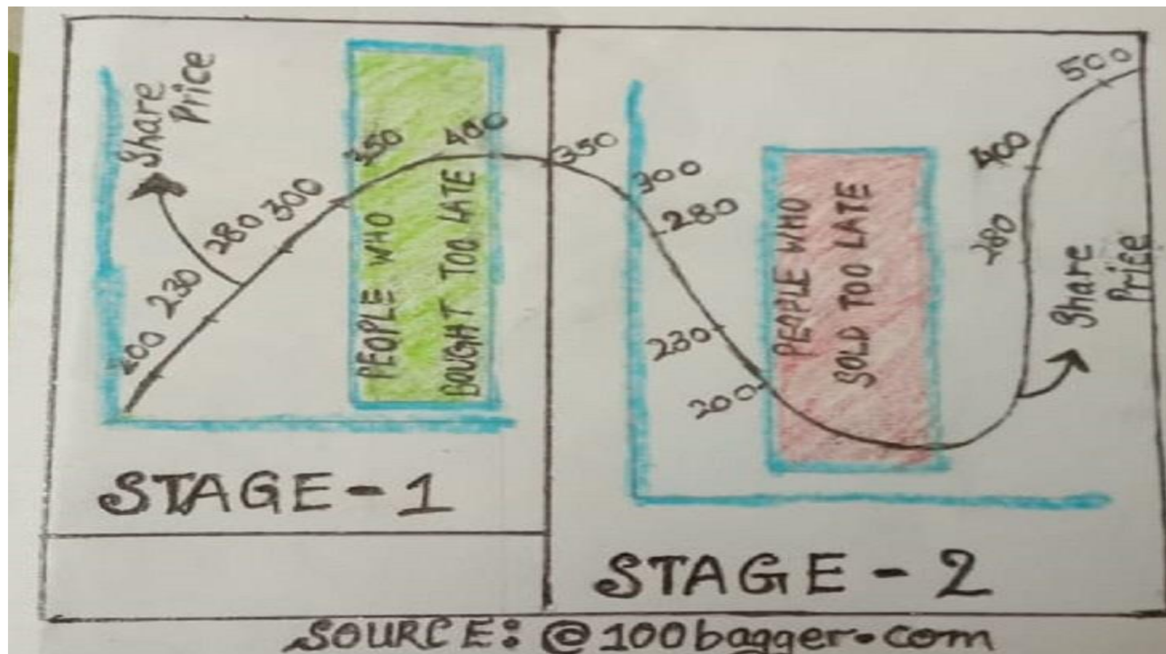
Decisions made with such a mind-set are irrational, illogical and illusionary, and inflicted by one's own thinking biases.

Therefore, once you know your position in the current cycle, divert your efforts towards working out the likelihood or probabilities of the next happenings.

For instance, imagine a certain event has played out and markets took a plunge by about 30-40% and valuation correction happens.

You will then know there is enough value and don't have to wait for the bottom. If you think about the likelihood of markets falling further and the amount of correction needed to justify an event particularly in the light of valuations, you'll have a good grip of the situation.

Instead of relying on blind prediction and getting swayed by the surrounding chaos, you could benefit from this practical approach.



Investors often fall into the noise trap. During the global pandemic in early 2020 caused by the deadly COVID-19, the entire market eco-system got panicky.

This paints a gloomy market picture resulting in a negative feedback loop. The more we hear about the spread of the disease, the more our worries grow.

This develops a belief system that nothing progressive will happen, and there will be more and more damage to the global economy and financial markets.

There is no doubt some of these worries are worth pondering about. The larger problem is, people build a notion around this crisis.

This triggers a self-propagated belief system, overpowering rationality, blinding people from seeing the accurate picture.

It is natural to get worried when something bad happens and feel happy when something good happens.

As a smart investor in a cycle, we must learn the art of looking at the actual picture. We can do it by looking beyond the optimism and pessimism around us.

Drivers of Action: When to act

First, we identify our position in the current cycle and look at the realities based on possibilities and probabilities of the future.

Next, we need to take any action based on our assessment of the future. For instance, let's think about a scenario where the market extends its rally and crosses substantially higher than the fair value zone.

Then we know that markets have entered the danger zone. The valuations are pointing irrational exuberance, but we're unsure about the timing and magnitude correction.

Important Note: The certainty of the future we know so far is not enough to benefit from what could happen.

Our principal job is to identify the risk posture and the requisite level of aggressiveness or defensiveness. We gain from the cycle if we identify those factors based on the prevailing market conditions.

Howard Marks in one of his Memos elaborates:

I feel strongly that it's possible to improve investment results by adjusting your positioning to fit the market, and Oaktree was able to do so by turning highly cautious in 2005-06 and highly aggressive in 1990-91, 2001-02 and immediately after the Lehman bankruptcy filing in 2008.

This was done on the basis of reasoned judgments concerning:

•how markets have been acting

•the level of valuations

•the ease of executing risky financings

•the status of investor psychology and behavior

•the presence of greed versus fear, and

•where the markets stand in their usual cycle.

Is this effort in conflict with the tenet of Oaktree's investment philosophy that says macro-forecasting isn't key to our investing? My answer is an emphatic "no."

Importantly, assessing these things only requires observations regarding the present, not a single forecast"

"As I say regularly, "We may not know where we're going, but we sure as heck ought to know where we stand."

Observations regarding valuation and investor behavior can't tell you what'll happen tomorrow, but they say a lot about where we stand today, and thus about the odds that will govern the intermediate term.

They can tell you whether to be more aggressive or more defensive; they just can't be expected to always be correct, and certainly not correct right away.

How to position oneself in a Cycle

Striking a portfolio balance is a crucial step to insulate it from major shocks and massive downward value deviations.

Keeping a lopsided portfolio on either side will probably expose the portfolio to risks. This means a highly aggressive portfolio may cause massive losses during the time of down.

And a highly defensive portfolio might not take advantage of the market during a bull run. Thus balancing and calibrating a portfolio is of utmost importance.

> Howard Marks in his Memo titled "Calibrating" dated April 6^{th}2020, said,
>
> *"One way to think about the balance between offense and defence is to consider the "twin risks" investors face every day: the risk of losing money and the risk of missing opportunity*.

At least in theory, you can eliminate either one but not both. Moreover, eliminating one exposes you entirely to the other.

Thus we tend to compromise or balance the two risks, and every individual investor or institution should develop a view as to what their normal balance between the two should be.

Next, investors might consider trying to calibrate their balance over time in response to conditions in the environment – thus the title of this memo:

- The more propitious the environment – the more prudently other investors are behaving, the better the outlook for earnings, and the lower security prices are relative to intrinsic value or "fundamentals" – the more an investor might want to shift toward offense.

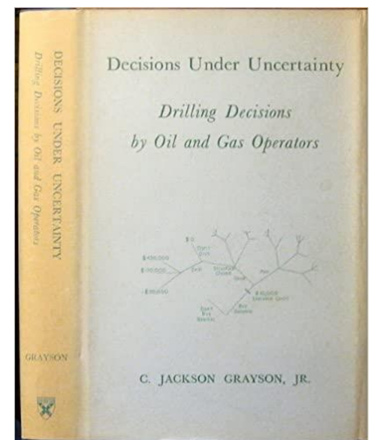
- On the other hand, the more precarious the environment – the more others are embracing risk, the more headwinds to profits there are, and the higher valuations are – the more an investor might choose to emphasize defence."

The quality of decision matters, not the outcome of the decision.

As discussed earlier we know the stock market and investing are not a perfect science. There are many variable elements including randomness that make a market cycle hard to grasp.

So even if we follow the most appropriate way to handle a cycle, the outcome can still be unfavorable. Therefore, to deal with and benefit from the cycle, investors need to have a sharp focus on the best process and judgment.

The focus should never be on the outcome, as it is unpredictable and random. Since his teenage years, Howard Marks was deeply influenced by a book called "Decisions Under Uncertainty: Drilling Decisions by Oil and Gas Operators" ***by C. Jackson Grayson, Jr.***



In his Memo titled You Bet! dated January 2020, Howard Marks writes

> "As Grayson explained, *you make the best decision you can based on what you know, but the success of your decision will be heavily influenced by (a) relevant information you may lack and (b) luck or randomness.*
>
> *Because of these two factors, well-thought-out decisions may fail, and poor decisions may succeed.*
>
> *While it might seem counterintuitive, the best decision-maker isn't necessarily the person with the most successes, but rather the one with the best process and judgment.*
>
> *The two can be far from the same, and especially over a small number of trials, it can be impossible to know who's who"*

The above reasoning does not mean; one should stop taking decisions. Since the decision is a prediction about an uncertain future, it can fail.

There would be times when the decision may not be successful, even though one makes the most informed decision, given the data and the environment prevailing.

There are 2 ways one can invest in a market.

a) If one is satisfied with an average return from the market, a decision-making skill is not required as one can just invest on a benchmark index.

b) When one aims for "above-average" returns, the decision marking skills come to the fore. It is thus essential to make an informed decision, taking into account the available data and the macro-economic scenario prevailing.

Whatever is the desired outcome which depends on many known and unknown factors including the role of luck, the one who takes this path is most likely to succeed.

One can judge the quality of an investment decision from the quality of the process followed to arrive at such decisions.

Chapter 7

Regularity of Cycles

In simple terms, a cycle refers to something that repeats constantly at fixed intervals. However, market cycles are different, because human emotions and many other factors which act randomly drive them.

We should not assume the cycles will be regular at certain times. Instead, they depend on the market condition itself.

We can describe regularity of cycle as a movement between undervaluation and overvaluation. This happens when investors move between the twin emotions of hope and fear.

We cannot mark it as a fixed period of a specific number of days, weeks or months.

"Extremes in cycles and trends don't occur often, and thus they're not a frequent source of error, but they give rise to the largest errors"

–Howard Marks

Origin of Cycles

Ever since life started on earth, cycles are present in all things around us, and markets are no different. The oscillation from the midpoint is also natural in everything, like health, wealth, professional life, social life and markets too.

This oscillation or fluctuation from the midpoint causes each cycle. The factors that contribute to this volatility are in existence since the birth of the markets.

"Cycles will never stop occurring. If there were such a thing as a completely efficient market, and if people really made decisions in a calculating and unemotional manner, perhaps cycles (or at least their extremes) would be banished. But that'll never be the case"

-- Howard Marks

Day-to-day cycles that we see in life around us and in the environment follow a set physical process. But emotion driven decisions of the market players create market cycles.

Hope and optimism in the market lure people to invest in stocks, and it spikes up the prices. This continues up to a point, after which the fear of a fall in prices and consequent losses creeps in.

This fear coupled with anxiety leads to decisions that actually cause this fall. So we should look at the regularity of market cycles through the lens of human emotions, but not as a mechanical process.

The Element of Randomness

"No rule always works, the environment isn't controllable, and circumstances rarely repeat exactly. Psychology plays a major role in markets, and because it's highly variable, cause-and-effect relationships aren't reliable"
–Howard Marks

We, humans have a tendency to look out for a trend, a similarity or a pattern in everything we see. So it's no surprise why investors too fall into this trap.

They closely look at market behavior and often indulge in keenly looking for patterns and similarities, which in reality never exist.

Market is like an unpredictable wild beast and market cycles are by-products of the same behavior. Hence they are understandably random and never follow a fixed pattern.

And this is precisely the reason cycles don't have a fixed start or an end. They keep rising or falling regardless of what any previous data or patterns suggest.

Like everything else in the world, cycles are not infallible and get disrupted by external events beyond anyone's control.

Natural disasters like earthquakes, tsunamis or virus outbreaks, sudden changes in world politics like coups or the declaration of war can throw market cycles into disarray.

However, it is important we realize that, though the market cycle changes continuously, we cannot eliminate it. Despite realignments that occur because of external events, the cycle itself continues to be a regular phenomenon.

For instance, the crisis caused by COVID-19 led to a massive fall in markets around the world. Fear and uncertainty depressed prices and led to an undervaluation.

But eventually, with the announcement of positive news, the pendulum will swing in the other direction and prices will rise, starting the cycle all over again.

Chapter 8
Misconceptions about Cycles

In the previous chapters, we discussed the importance of cycles and how to deal with them. Another important aspect is to understand the true meaning and nature of cycles.

There are many popular misconceptions about market cycles. In this chapter, we discuss a few of them and try to remove the layers of fallacy or common delusions.

Assuming similarity between two Cycles

Cycles are an overarching concept. Cycles are a recurring phenomenon, but that's where the similarity ends. It is a common mistake to assume that their duration will be the same or like that of a previous cycle.

Also, to assume the rise and fall in the number of points will be like previous ones is incorrect. Visualizing similarities, drawing patterns, finding parallels, guessing a previous similar trend, could lead to wrong conclusions.

Cycles will never have a similarity with any of the previous cycles or situations. They could differ in duration, magnitude, length, the sequence of events, and any other attributes that drive them.

It thus can be a fatal folly to assume a pattern and draw a conclusion. Also, the drivers of these cycles, such as fundamentals, emotions, and liquidity, are often the same in some proportion or combination, but not identical.

It is possible to time a Cycle

Because our educational system is so hung up on precision, the art of being good at approximations is insufficiently valued. This impedes conceptual thinking.

–Ray Dalio

Often people try to get it "perfect". They attempt to buy a stock at the absolute lowest price it hits and sell at the absolute highest price it touches. It is impossible.

Cycles are a general trend of stocks being cheap or expensive. This means that sometimes companies sell their stocks at a lower price than their actual worth.

And sometimes their stock price is higher when compared to their actual worth. As discussed in previous chapters, it is impossible to time the cycle. Even the most intelligent investors have failed in doing so.

Cycles can help foresee the future

Many people see cycles as a way of predicting the future. However, it's in fact a recognition of a simple fact that the price of a stock and the value of a stock is not the same thing.

Also, there will be a constant fluctuation in between the two. When investors are pessimistic, even high-quality stocks with good fundamentals and future potential, sell at a lower price than their actual worth.

And when investors are overly greedy and optimistic, even low-quality stocks with bad fundamentals and other defects, sell for a price higher than their actual worth.

Understanding market cycles is more a mechanism to evaluate a stock's current worth, value, and quality relative to its price. This helps to determine if it under or overpriced. However, this should not be a means to forecast its future price changes.

A handful of factors can determine Cycles

Cycles result from various events and factors and are not one thing by themselves. They get influenced by a range of factors, from market fundamentals to liquidity, to sentiments. It is hence a mistaken notion to assume that a cycle depends on only one or two factors.

"This time it's different"

> *The biggest misconception about cycles is that investors always assume "This time it's different". The problem starts at the extreme point of the cycle when a new belief system sets in. In a rising market, they think it will continue to rise and in a falling market, they expect the fall to continue.*

Over the decades many people have made such claims, but it has all been proved wrong. Cycles are a fundamental part of individual markets. No matter what happens, the stock market graph will never be a straight line.

Downturns are bad

No part of the cycle is risky for an intelligent investor who understands cycles. Many people think the bearish or the falling phase of an economic cycle is always bad or damaging for an investor.

This is not always true. If an investor positions himself and his asset allocation based on the market cycle, every point of the cycle provides a fair opportunity for growth and profit. This is regardless of whether prices are rising or falling.

Chapter 9

Benefiting from the Greed-and-Fear Cycle

Warren Buffet's advice epitomizes the most successful and basic strategy when it comes to benefitting from market cycles. He once said, "Be fearful when others are greedy. Be greedy when others are fearful"

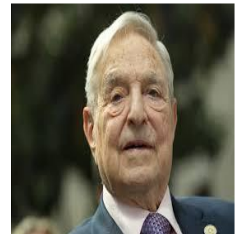
"Successful investors tend to be unemotional, allowing the greed and fear of others to play into their hands. By having confidence in their own analysis and judgement, they respond to market forces not with blind emotion but with calculated reason. Successful investors, for example, demonstrate caution in frothy markets and steadfast conviction in panicky ones. Indeed, the very way an investor views the market and it's price fluctuations is a key factor in his or her ultimate investment success or failure"

~ Seth Klarman

Understanding the Boom-and-Bust Cycle

Boom and bust or greed and fear are the permanent nature of the markets; thus, dealing with them is an equally important task in managing market cycles.

The billionaire investor and one of the biggest traders, once said:



> ***First, financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times, it is quite pronounced. When there is a significant divergence between market prices and the underlying reality, there is a lack of equilibrium.***

-- ***George Soros***

I have developed a rudimentary theory of bubbles along these lines. Every bubble has two components: an underlying trend that prevails in reality and a misconception relating to that trend.

When a positive feedback develops between the trend and the misconception, a boom-bust process is set in motion.

The process is liable to be tested by negative feedback along the way, and if it is strong enough to survive these tests, both the trend and the misconception will be reinforced.

Eventually, market expectations become so far removed from reality that people are forced to recognise that a misconception is involved.

A twilight period ensues during which doubts grow and more and more people lose faith, but the prevailing trend is sustained by inertia.

As Chuck Prince, former head of Citigroup, said, 'As long as the music is playing, you've got to get up and dance. We are still dancing.'

Eventually, a tipping point is reached when the trend is reversed; it then becomes self-reinforcing in the opposite direction.

Typically bubbles have an asymmetric shape. The boom is long and slow to start. It accelerates gradually until it flattens out again during the twilight period.

The bust is short and steep because it involves the forced liquidation of unsound positions. When prices are rising is not the best time to invest.

According to Warren Buffett

One benefits the most by entering the market at the time of fear when most investors are fleeing and market valuations are low, and by staying away or exiting markets when people are excessively greedy, causing a boom or a level where markets and stocks quote at very high valuations.

In his 1987 letter to Berkshire Hathaway shareholders, Buffett writes about this in detail, which is key to dealing with the greed-and-fear cycle.

Buffett Writes:

Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success.

He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business.

Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems.

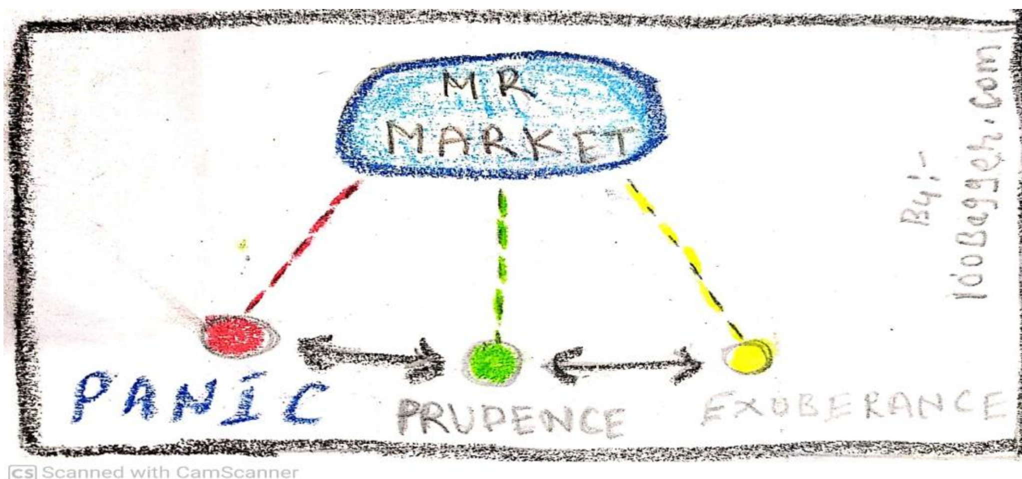
At times he feels euphoric and can see only the favorable factors affecting the business.

When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains.

At other times he is depressed and can see nothing but trouble ahead for both the business and the world.

On these occasions, he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow.



Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you.

It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence.

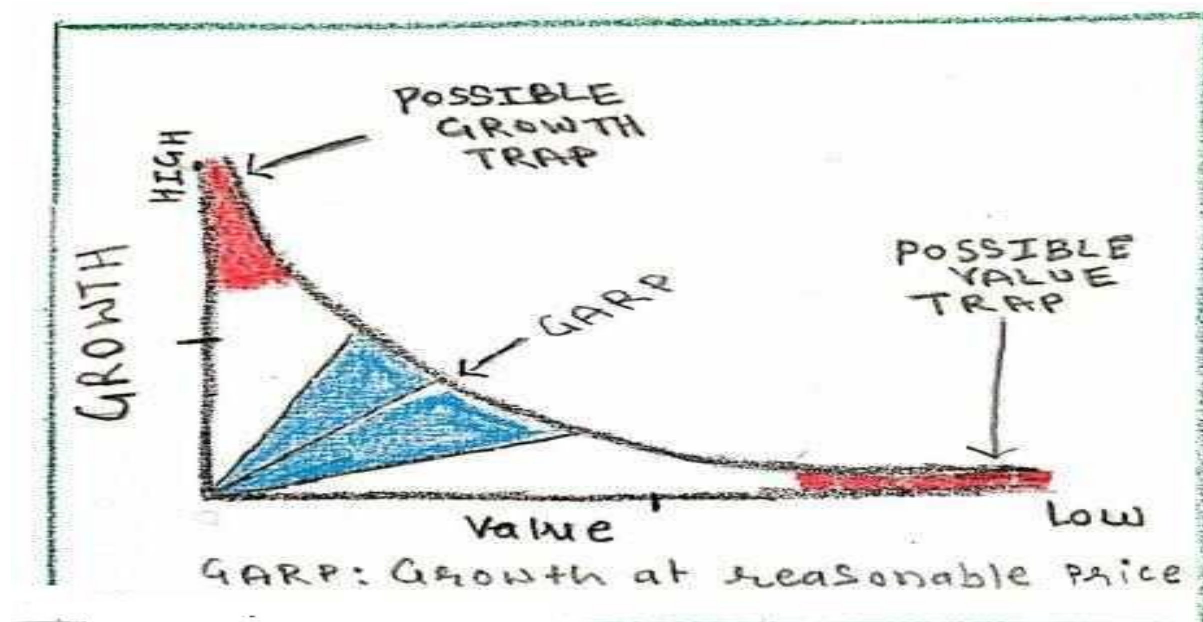
Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game.

As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."

Price vs. Value

One good thing about the greed-and-fear cycle is that investors who focus on value or people who know the intrinsic value of businesses, are far better equipped and the biggest beneficiaries of the greed-and-fear cycle.

Almost all the gurus, including Benjamin Graham, Warren Buffett and Howard Marks, suggest that to deal with the cycle, as investors, our primary job is to keep a sharp focus on the business and its intrinsic value.



Black-Swan events or sudden improbable situations tend to have a larger impact on the economic system in general and investment behaviour in particular.

The market tends to react sharply to such events and investor behavior, too, tends to replicate this. Hence, this often leads to panic selling. The recent Covid-19 pandemic is an example.

In times of crisis caused by Covid-19, Howard Marks. in his memo titled, Nobody Knows, dated March 3rd 2020, writes:

“There’s no doubt about the fact that the coronavirus represents a major problem, or that the reaction so far has been severe. What really matters is whether the price change is proportional to the worsening of fundamentals.”

He further writes, “For most people, the easy thing is to say that (a) the disease is dangerous, (b) it will have a negative impact on business, (c) it has kicked off a major reaction to date, and (d) we have no way of knowing how

far the decline will go, so (e) we should sell to avoid further carnage.

But none of the above means selling is necessarily the right thing to do. “In order words, the investment decision must be based on the relationship between price and value.

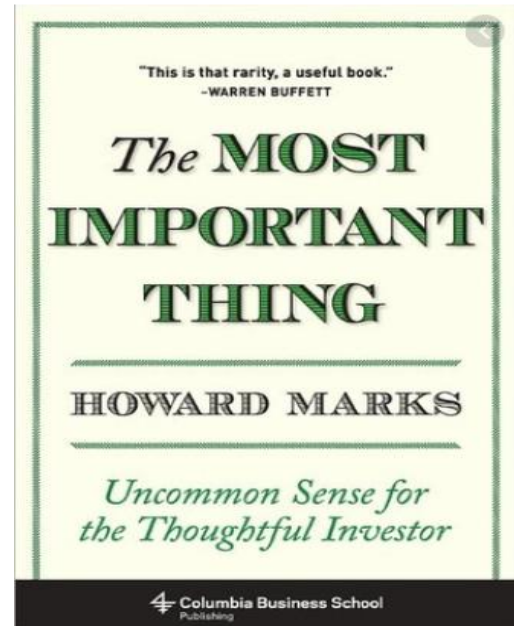
One needs to ask oneself relevant questions such as “Is the security priced right given the fundamentals”. If the answer to the question is in the affirmative, the correct long-term decision would be to buy securities rather than sell them.

While one can never be certain, one needs to judge whether the market is overvalued or undervalued and make decisions accordingly.

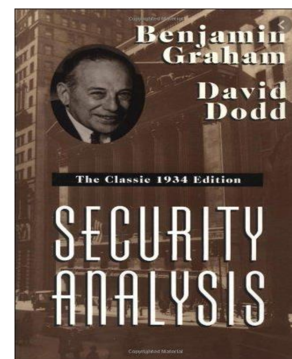
As events are fluid and dynamic, one needs to study market cycles and assess the behaviour of markets in such Black Swan-like events.

Howard Marks concludes the memo with a perfectly balanced view:

> ***"Stocks may turn around and head north, and you'll be glad you bought some. Or they may continue down, in which case you'll have money left (and hopefully the nerve) to buy more. That's life for people who accept that they don't know what the future holds."***



According to Benjamin Graham while securities have an "intrinsic" price based on their true worth, their market price fluctuates wildly based on market sentiment.



His strategy and indeed the cornerstone of value investing was to buy when a market cycle brought the market price below the intrinsic value, and to sell when the cycle took the price above it.

He, however, learned this lesson the hard way. In the 1929 crash he lost nearly 70% of his investment for a variety of reasons such as not adjusting to the market cycle.

Later on, he became a much more conservative and proactive investor, avoiding leverage debt margins and moving his investments into bonds when market conditions seemed precarious.

The important takeaway here is that investors who know the value of a business or focus on the intrinsic value of a business can benefit greatly while dealing with these events and cycles of boom and bust.

During the 2008 crisis when prices were at all-time lows and investors were fleeing the market Warren Buffett plunged in with massive investments in Goldman Sachs, with 5 billion dollars on preferential shares, with an investment of 23 billion, which helped finance its takeover of Wrigley.

Just a few years later he made a profit of nearly 10 billion dollars on his investment when most people were losing most of their investments.

Warren Buffett here followed his own simple advice, he was fearful when others were greedy, holding back when share prices were sky-high, and was greedy when others were fearful, swooping in to purchase quality stocks at rock-bottom prices.

Authors

Chartered Accountant Kushal Gupta has over five years' experience and is an enthusiastic student of the stock market and value investing. A firm believer in worldly wisdom and an avid reader, he follows Charlie Munger and Warren Buffett's style of investing.

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With a business management degree, Puneet Kakri has worked in the banking sector in credit appraisal. His exceptional eye for detail when analyzing financials always brings in the right perspective. Apart from his interest in financial markets, he is passionate about reading and writing.