Fear and greed – April 2024

By Ross Reuvers & Edo Brasecke

Until the dot-com bubble burst in 2000, few people had considered the impact investor psychology has on markets.

The dominant idea had been that investors always make rational decisions. Even when they got things horribly wrong, it was generally accepted that they had logical reasons for doing so.

However, the dot-com bubble was so clearly a case of investor mania that this thinking had to be questioned. The share prices of many internet companies that didn't even have real business models were pushed higher and higher because people just wanted to be in on the action. It was investing driven entirely by sentiment, not logic.

It may sound obvious to say all of this now, but it wasn't accepted wisdom twenty-five years ago. The idea that market prices could be based more on what people felt than on good economic sense was a long way from the mainstream.

There were, however, some astute people who had long since understood this reality. Most famously, Warren Buffett wrote in the Berkshire Hathaway shareholder letter of 1986:

"Occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable, and the market aberrations produced by them will be equally unpredictable, both in duration and degree.

“Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: We attempt to be fearful when others are greedy and to be greedy only when others are fearful."

These words have become so well known because they are perhaps the most succinct description of why we have market bubbles and market crashes that has ever been written.

When investors become exuberant and therefore “greedy” about the apparently easy returns they are making, you have episodes like the dot-com bubble. When massive uncertainty hits and investors are “fearful” about losing money, you get the sort of crash you saw in early 2020 when governments started shutting economies down because of Covid.

However, this does not only occur in big market moves. It happens on an individual level all the time.

No matter how good they might be, at some point, every investor will face the challenge of becoming overly fearful or increasingly greedy. It's human nature to be swayed by our emotions.

This isn't necessarily a bad thing. We rely on our emotions to guide us all the time, such as when making friends or deciding what to have for dinner.

But when making investment decisions, emotions are less helpful. Greed and hope have caused many investors to chase "the next big thing" or hold onto an underperforming investment for too long. Fear and discomfort have caused them to sell good performers too early or avoid unpopular opportunities altogether.

In the time we've spent in the investment industry, we've realised that we're just as prone to this as anyone else. No matter how rational we might think we were at the time, we can always look back at our decisions and acknowledge that there were times when our hearts overruled our heads.

This is a big part of what has led us to systematic investing. We don't want what's in the Methodical BCI Equity Fund portfolio to be a reflection of what we're feeling, or the predictions we're making, or the hopes and fears we have for the future. We want it to be consistently and reliably decided by the rules we have put in place to capture a very specific market phenomenon – share price momentum.

Put more simply, we believe investors should be protected from our biases. If we can't be certain that the decisions we make will always be rational, then we think it is better to have everything decided by a clear set of rules that are not influenced in any way by our emotions.

The added benefit to investors is that they can be certain that the way decisions are made isn't going to change. What the fund does will always be consistent. It won't be swayed by fear or greed, because the rules we have put in place don't care what we, or the market as a whole, are feeling. Instead, they just repeatedly and predictably make sure that the sorts of shares we want in the fund will be there, regardless of the sentiment.