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Money moves in waves

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Money doesn't flow, it sloshes, says Richard Sipley in **'Market Indicators: The best-kept secret to more effective trading and investing'** (www.bloomberg.com). Like water in an overfull bathtub, money moves in waves, as investors process information and balance the competing desires to grow wealth and protect capital, he adds.

"Traders use connections and quick thinking to react to new information, deciding how it may (or may not) affect capital returns. Thoughtful investors try to proactively position portfolios, rather than reacting impulsively to each new data point and market development."

Importantly, as Sipley explains in his book, the sloshing money creates a variety of measurable results, which signal how investors currently view risk and where they are placing bets. For instance, VIX, the volatility index introduced by the Chicago board Options Exchange in 1993, considers stocks traded on the S&P 500 Index and continuously calculates their implied volatility on a constant, forward-looking 30-day basis.

The VIX is also known as the investor fear index, because upward spikes are associated with bouts of market turmoil and uncertainty, the author informs. "Market participants are generally reluctant to put hard-earned cash to work in the market when the future seems murky and unsettled. Other investors may see reluctance as an overreaction to current news events and, therefore, as a buying opportunity."

A chapter on 'big money' has nuggets of statistics such as that globally, private institutional investors managed over $60 trillion at the end of 2006; and that hedge funds nominally controlled almost 1.9 trillion in assets at the end of 2008.

Engagingly, there are also simple analogies. "We might think of hedge funds as a flashy sports car, one with good acceleration, good handling, a small trunk, and no towing capacity. Institutional money, on the other hand, is more like an 18-wheeler, with poor acceleration and handling, but great storage and towing capacity."

Sipley elaborates on the parallels, saying that institutional funds, which don't like to make frequent changes to their investments, are like a semi truck driving straight down the highway than attempting tight turns. "But when they do adjust a portfolio, their huge size makes outsized moves of their buying and selling. Like the fat man doing a cannonball dive, institutional investors make big waves."

Ordinary investors are so human that they avoid pain and seek pleasure in ways that generally lead to poor investment decisions, the author rues. "Humans have an unfortunate knack for getting out of the market at the bottom when all the news is bad and stocks have generally suffered, and back in towards the top when the news is generally good and the coast seems clear. This tendency prevents many investors from maximising returns."

He cites a study by Dalbar Financial Services, which showed that over the previous two decades, when the market returned an average 11.8 per cent per year, the average investor got an average 4.3 per cent annualised return, because of ill-timed entrances and exits.

"A buy-and-hold investor could turn $10,000 into $85,094 over twenty years; an 'average' investor would have $23,210. That's the difference between a comfortable retirement and a more difficult one."

The book closes with a set of sixteen rules that investors can benefit from. 'Keep it simple,' reads the first rule. "If you're looking for your investment rationale on the twentieth page of a spreadsheet, chances are it won't go as well as planned," the author cautions.

Another rule, inspired by Benjamin Franklin ('Believe none of what you hear and half of what you see'), says that scepticism, though it may not make you the life of the party, will help your investment returns over time.

"Look for the downside first, the worst-case outcome of any given decision. The upside will take care of itself," Sipley advises. He urges investor to invert, as mathematician Carl Jacobi suggests. "When faced with a tough problem, invert the problem (or situation) and look at it from another point of view. In terms of investing, it can mean challenging your assumptions and seeking out alternative and opposing views."

The penultimate rule exhorts investors to lead balanced lives. "Turn off the television, go for a walk, play with the kids. It's easy to get caught up in the twenty-four -hour, hyperkinetic news cycle and succumb to the pressure to feel you're fully informed. It's not possible, and it's counterproductive," Sipley counsels.

At the end of the book is a sine wave titled 'the investor sentiment cycle,' symbolising the final rule, 'This too shall pass,' as King Solomon philosophises. When you're in the middle of a ripsnorting bull market, it seems that good news and rising stock prices will last indefinitely, and the nastiest bear markets seem to bring unending gloom, Sipley notes.

"But everything runs in cycles, an axiom that's especially true for the stock market." Spots, therefore, on the 'sine wave' begin and end with 'optimism'; and in between are a range of emotions: excitement, thrill, euphoria (at the peak), anxiety, denial, fear, panic, capitulation, despondency (in the trough), depression, hope, and relief.

Important addition to the investors' shelf.

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