

Is too much information making us worse investors?

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Key points

- A massive increase in economic and financial information flow is adding to investor jitters and driving a shift further away from long term-investing. This is likely to work against investors over time.
- Investors should consider turning down the 'news volume' and refocus on investing for the long term, remembering the best time to invest is when everyone is gloomy. Averaging into weakness is a good way to go.

Introduction

It's self evident there is a long worry list for investors right now. There are fears Greece will bring down the European economy and lead to another Lehman-style event. The US economy has slowed, ending the second round of quantitative easing and politicians are squabbling about increasing the US Government's debt ceiling. In China and emerging markets, there are worries policies to slow inflation will cause a hard landing. Australia has its own overlay of worries around further interest rate hikes, the strong Australian dollar and uncertainty around government policy, notably the carbon tax. Natural disasters, such as floods, earthquakes, tornadoes and volcanic eruptions have only added to the sense of unease.

Last week, one financial planner told me that he had never before felt such a sense of fear on the part of clients. And a client recently asked me whether analysis based on past events is of any relevance in a world of more frequent natural disasters.

All these worries are real and this has me wondering whether 24 hour news cycles, combined with the information avalanche we are now being smothered with, are actually improving the information flow to investors or has it just made investors more fearful, short sighted and jittery? Has it led investors to a short-term focus which is not in their long-term financial interest?

Has the world become worse?

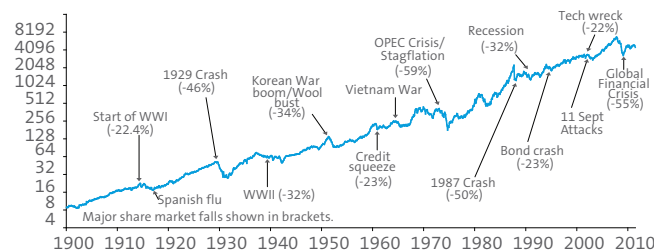
There is no doubt the global financial crisis has left the world with a hangover in the form of excessive debt levels, extreme monetary policy settings in advanced countries, excessively easy monetary conditions in emerging countries, a greater reliance on the more volatile emerging world and increasing business regulation. This is resulting in shorter, more volatile business cycles and an increase in the importance of asset allocation. At the same time, talk of looming physical crises such as a peak in global oil production, food shortages, resource depletion and global warming, are only further adding to the sense of trepidation, which has not been helped by this year's run of aforementioned natural disasters

But has the world really changed? The global economy has been through difficult phases in the past and we got through it. The last century has been full of disasters and catastrophes. Here's a sample: Early 1900s – San Francisco earthquake, US financial panic, World War I and Spanish flu pandemic; 1930s – The Great Depression and World War II; 1950s – Korean War and flu pandemic; 1960s – credit crunch, Cuban missile crisis, Vietnam

War and flu pandemic; 1970s – Organisation of Arab Petroleum Exporting Countries oil embargo, US Watergate scandal, Iranian revolution and second oil crisis; 1980s – Latin American debt crisis, Chernobyl nuclear disaster, global share crash, first Gulf War, Japanese bubble economy collapse and US savings and loan crisis; 1990s – second Gulf War, Asian financial crisis and tech wreck; 2000s – September 2001 terrorist attacks and Lehman Brothers collapse. Over the years, Australia has regularly been hit by droughts, floods, cyclones and bushfires. The rest of the world has also seen a regular, wide range of natural disasters.

And yet, despite this litany of disasters and periodic swings since the 1900s, Australian shares have returned 11.8% per annum (or 7.7% pa after inflation), which is double both the 5.9% pa return from bonds over the same period and 5.3% pa returned on cash since 1926.

Australian Shares have climbed despite a litany of disasters



Source: ASX, AMP Capital Investors

And if you are worried the world is about to hit some sort of limit in terms of growth, population, resources or the environment, after which will come some sort of great disruption, bear in mind such prognostications have been regularly been made over the last two hundred years, to no avail. Thomas Malthus in the 1800s, Paul Ehrlich in the 1960s, the Club of Rome report on the Limits to Growth in 1972, to name a few. Such analyses dramatically underestimates resources, the role of price increases in driving change and the role of technological progress in facilitating it and heading off disaster.

Maybe the world has become more problematic, but I doubt it. When I think of what my parents went through such as the Great Depression, loss of infant siblings, numerous wars and post war recessions, I find it very hard to agree that life is harder today than it was when they were growing up.

Or are we suffering from information overload?

While not to deny the current list of worries, one wonders whether the communication revolution is making the list seem worse than it really is. Thanks to increased access to information, we are now bombarded by news on a continuous basis. Whether it's on the television via regular updates on numerous news and finance channels, or through websites, blogs and twitter on smart phones, it's hard to escape.

The trouble is, much of this is background noise and random movements in economic data, due more to statistical aberrations than fundamental swings in the economy. Second order economic data of no real significance, gyrations in share prices and currencies reflecting swings in sentiment on the day and, in Australia's case, constant chatter about interest rates is reflected in opinions and commentary. And of course bad news sells better than good, which is why, for example, we hear so much about Greece, which accounts for less than 2% of the European economy, compared to

Germany, which is doing fantastically well and accounts for 20%.

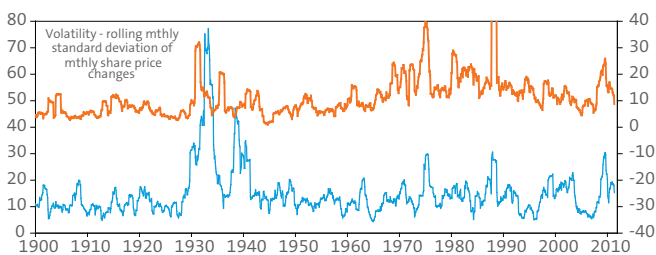
Much of this is just a soap opera, but it seems so much is going on and all invariably bad. One could be forgiven for thinking we are now in a constant state of economic crisis. Too much economic and financial information was the subject of an excellent article by former Reserve Bank Governor Ian Macfarlane in the Australian Financial Review (AFR) on 6 June 2011.

Is this helping us?

As Macfarlane did, we can wonder whether all this extra information is actually helping us become better investors. I agree with him and doubt it is. In theory, the improved flow of and access to economic and financial information should be making for better, more efficient investment markets. However, it is doubtful this is the case.

Academic economists focus on two types of market efficiencies. The first is the speed with which new information is reflected in the price of shares and currencies and the second is whether it is done so in a rational way. On the first point, it's likely we have made great strides as the democratisation of information has seen financial prices reflect new information quickly. But there is little evidence that all the extra information is resulting in more rational pricing in shares and currencies. Asset bubbles and busts are as common as ever. The following chart shows the volatility in US and Australian shares is pretty much in the same range it has been over the last century. In fact, it's odd how constrained volatility was in the relatively information starved pre-1930s.

Share market are as volatile as ever 'improved' information flows



Source: ASX, Global Financial Data, AMP Capital Investors

Most importantly, there is no evidence that the extra information is leading to consistently higher returns for investors. In fact, ever since the information revolution in the late 1990s, the US and global shares have just spun their wheels!

In fact, at the individual investor level, it's likely the increased flow of information might be adversely affecting investors. As Macfarlane alludes to in his AFR article and I, myself, have heard from ordinary investors recently, the constant information bombardment is likely making investors excessively cautious, which means they are less to a greater short-term focus, boosting short-term speculation relative to medium-and longer-term investment. This in turn is likely to be negative for the economy. As John Maynard Keynes once observed, "when enterprise becomes the bubble on a whirlpool of speculation [and] the stock market takes on the attitude of a casino, the job [of capitalism] is likely to be ill-done¹."

¹ For a wider discussion on this, read 'The Clash of the Cultures', by John C. Bogle, published in The Journal of Portfolio Management, Spring 2011 edition.

Related to this, I wonder whether the Reserve Bank of Australia has made the obsession with interest rates worse with almost weekly post meeting communiqués adding to the sense of permanent crisis in Australia. Surely we were doing perfectly well without all this extra news on interest rates?

So what should investors do?

Against this backdrop, there are three things investors should do. Firstly, turn the volume down on the news front, consume less of it. Secondly, adopt a long-term strategy and stick to it. Sure, the environment we are in now has increased the importance of asset allocation, but this is best left to experts and those who really put the time in. Most individual investors will end up getting it wrong, so the best approach is to agree to a long-term strategy and stick to it. Thirdly, for those with a bit of spare cash, the best approach is to 'buy in gloom'. In other words, follow the advice of Warren Buffet when he said "get greedy when everyone panics, panic when everyone gets greedy". With shares down, but short-term risks of further falls remaining, perhaps the best way to do this is to average in over the next three or four months.

It's not all terrible

For those prepared to look beyond current worries and for positives, it's worth noting there are actually quite a few:

- International cooperation is on the rise, for example, the Libyan intervention and the global decision to release oil reserves.
- Since their highs earlier this year, world oil and raw food prices have fallen 15 to 20%, which will take pressure off inflation and household budgets.
- The Japanese economy is rebounding from the earthquake, which should reverse the negative global supply chain impact seen in the last few months.
- Chinese Premier Wen Jiabao has expressed confidence inflation will be firmly under control and there are technical signs Chinese shares may be bottoming.
- Global monetary conditions remain very easy.
- The US Federal Reserve appears to have been successful in heading off the deflation threat of a year ago. This is great news considering the pernicious impact entrenched deflation would have had.
- Shares are as cheap as they were at the end of the last major correction mid last year.
- Emerging countries now account for more than 50% of global economic activity and have strong growth potential.
- Australia is going through the biggest mining boom in our history. While this is causing pain for some parts of the economy, we are nevertheless seeing a huge boost to national income and the massive degree of mining investment augurs well for future growth.
- Finally, everyone seems bearish. This may sound perverse, but it's often a positive sign.

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