

# Maybe Those Persians Were Onto Something

Philosophers and social scientists tend to see the world as a battle of opposites: good versus evil, yin versus yang, id versus ego, the Red Sox versus the Yankees. They usually recommend melding the two, believing the truth is not one-sided, but a combination of opposites. This desire for a synthesis is not a recent phenomenon. Herodotus tells us the ancient Persians would make all major decisions while drunk, and then reconsider the decisions the next day while sober. If the sober decision agreed with the inebriated decision, they would go forward; if not, the process would be repeated.

The financial markets daily illustrate a battle between reality and emotion. Reality consists of the business fundamentals underlying stock prices. Emotion is reflected in how investors are willing to capitalize those fundamentals, how happy or sad we are at a given time. If you (and nobody else) know that tomorrow the government will release a statistic indicating a strong economy, would you buy or sell? Will the markets be happy with the statistic (the economy is improving!) or sad (this means the Federal Reserve will raise interest rates!). The fact you have to pause should tell you something.

During the huge bull market from the middle of 1982 through the end of 1999, aggregate earnings for large U.S. companies roughly tripled. The Dow Jones Industrial Average started the bull market at a level of about 800, so the increase in earnings “explained” a rise in the Dow from 800 to about 2,400. The rest of the gain, from 2,400 to the Dow’s high above 11,700 was the result of investors feeling happier. The change in emotion explained over five times more of the bull market than the change in the underlying reality of earnings.

Sigma admits a bias towards the logical and away from the emotional. Our rationality tells us, however, that if we were given a choice between knowing future business fundamentals or the future emotional state of investors, we would definitely pick the latter. If we are at maximum happiness, as we were at the market high in early 2000, there is a ceiling on how much farther the market can go – even favorable changes in business fundamentals may matter little if investors become sad. If we are at maximum sadness, the market can go up, even in the face of unfavorable changes in business fundamentals, if investors get happier. If you are making a prediction about future market movements, you need to not only predict the reality of underlying fundamentals, but the direction of future investor sentiment.

*It is not enough to predict future reality  
– you have to be able to predict whether  
we’ll be happy or sad about the reality.  
We know we’re not that smart, and we  
are skeptical of anyone claiming they are.*

Investors were particularly giddy at the end of 1999, roughly the peak of the technology boom in the stock market. Investors were particularly glum in June 1982, after a decade of inflation and a stumbling economy. Market history tells us that while there may be an average degree of happiness or sadness among investors, there is no

normal. Investors tend to swing from manic exhilaration at market tops to abject despondency at market lows. You can calculate an average valuation level using the price/earnings ratio or other indicators as measures of investor psychology, but it is like standing with your head in a freezer and your feet in an oven – the “average” temperature sounds more comfortable than reality. In the market, we tend to only hit “average” briefly while we are rushing from one excess to another. Fundamentals matter, but they are just the midpoint between the extremes. A swing towards manic or depressive madness may occur in the markets, but it cannot last forever. Our emotions can be strong in investing, but fortunately they are ultimately tethered to underlying reality. No tree grows to the sky, and no hole goes all the way to China...or Persia.

We are not claiming to be able to predict the future of investor emotions. Our point is that predicting future earnings, interest rates and the like is an arid exercise in futility. Even if your predictions are accurate (and they most likely are not), you also have to correctly predict how investors will feel about the result, or you have nothing that will help you make money investing. We prefer to stay out of the prediction business, focusing on thoughtful asset allocation, diversification and manager selection.

Speaking of the ancient Persians, they could also have helped us avoid the corporate scandals of the past few years. Herodotus writes that the two great disgraces in Persia were to lie or owe money. The main reason for their dim view of debt was their belief that somebody who owes money is likely to tell lies. If you would like the wisdom of ancient Persia and modern investment theory working for you, give us a call at (503) 419-3938 or check us on the web at [www.sigmainvestment.com](http://www.sigmainvestment.com). If you hear a raucous party in the background when you call, we’re probably just making an important decision.