

The conundrum of rising equity markets

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The team at Tacit are regularly asked how our strong performance has been achieved over the past 16 years. Our answer is always a simple one: we try not to overact to what markets have just done.

As markets rise, you can sit in one of two camps as an investor: either the optimist that believes that the recent trajectory will continue or the pessimist that looks for every reason why this cannot last. History suggests that it is very difficult to be consistently right one way or the other. The only thing history does show us is that equity markets, the discounted value of future nominal cash flows, rise over time.

Over the longer term, the maths is very straightforward. As an equity owner, you own a share of future profits. As economies expand, productivity improves and successful businesses reinvest, those cash flows have historically tended to grow. Shareholders participate through earnings growth, dividends and share buybacks. The relationship between economic growth and equity returns is not one-for-one, as valuations, profit margins and changes in the number of shares outstanding also matter, but over long periods the growth of corporate earnings and dividends has been a major driver of equity returns.

So why do so many of us look for the problems rather than embracing the basic mathematics?

Investors feel potential losses more intensely than equivalent gains because of loss aversion, a core principle of behavioural finance rooted in prospect theory. Research by Kahneman and Tversky shows that the psychological pain of losing \$100 is roughly twice as powerful as the pleasure of gaining \$100. This asymmetry skews decision-making: investors become overly risk-averse when facing possible gains but paradoxically risk-seeking to avoid crystallising losses. Consequently, they often sell winning investments too early to “lock in” gains while holding losing positions too long, hoping to break even- a pattern known as the disposition effect.

Equity markets can rise or fall from year to year, however markets falling consistently for year after year is unheard of mainly because of the simple mathematics explained above. Global recessions are relatively rare because economic activity is diversified across countries, industries and sources of demand. They nevertheless occur, and investors must construct portfolios capable of enduring them.

In reality, looking back and explaining what happened is easy, that's what market commentators do, looking forward without feeling nervous is much more difficult. It's one of the reasons so many professional investment managers perform poorly in our view, they get stuck between looking for explanations and the mathematics they are taught when training. Containing these urges, whether excessively positive or negative, through a well-structured investment process grounded in historical evidence is probably at the heart of why we have been able to produce strong inflation and risk adjusted returns for our clients in a world that seems riskier by the day.

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