

The Pendulum Never Stops...

By Dan Richards*
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Occasionally, something we hear sticks in our minds and stays with us.

When I was at the Harvard Business School in the 1970s, my finance professor used a phrase that I often find useful in conversation with clients and investors - especially in markets such as we're in today.



Today, many advisors who are fundamentally positive about prospects for the market are struggling with the best way to get clients to buy into that enthusiasm.

That phrase: *"The pendulum never stops in the middle."*

This professor was one of the big names in the field - he consulted with many of the Wall Street firms and was frequently quoted in the press.

He used this phrase in the context of market valuations and market sentiment. He talked about the historical reality that markets inevitably swing from one extreme to another, from periods of outlandishly elevated valuations to ridiculously beaten down levels, and from periods of unquestioned euphoria to absolute pessimism.

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"The pendulum never stops in the middle" applies in lots of other cases.

Look at the today's attitude to risk and leverage, especially as it is portrayed in the media. Companies that were fiscally conservative and didn't borrow to the hilt to boost



profits were criticized for failing to maximize shareholder value. (The most popular article in the online New York Times recently was a piece laying out Canadian banks as the model for the global banking system - a notion that six months ago would have been completely absurd.)

Consider investors' attitudes to owning resource stocks. Not long ago loading up on these was all that many investors wanted to talk about, but today they don't even want to hear about owning resources.

This is also reflected in expectations of oil prices. A year ago, the "peak oil" theory held sway and demand from China and India was going to push oil to \$200 by year end. Today we've begun to hear about the "peak demand theory" - the view that demand for oil peaked last year and we'll never, ever see demand at that level again. With the benefit of hindsight, the first forecast is now clearly absurd - and almost certainly the second one will be equally so.

Recall all the investment fads and "flavor of the day" investments.

And think about the wild swing in consumer sentiment toward appropriate spending habits - from the norm of lavish expenditure to "the new frugality."

My finance professor's key point was that while the stock market may be efficient and rational over the mid- and long-term, in the near-term the "swinging of the pendulum" creates terrific opportunities for companies and for investors who can maintain their perspective.

That was true thirty years ago ... and it's arguably even truer today

The challenge is how to convey this to clients in a way that they can understand and relate to.

Let's start with the good news: The concept of the "pendulum swinging" will intuitively make sense for most investors.

Having introduced this notion, you could go on to say that it captures two of the most important and widely recognized truths about investing.

The first truth is that what really drives markets to their extremes are the twin emotions of greed on the upside and fear on the downside. Both can be hugely costly - and it takes real discipline and resolve to withstand the forces of those emotions as the pendulum moves through its arc.

You can refer to the second truth - the costliest advice for investors is "it's different this time."



Seasoned investors know it's never different. As just one example, those investors who listened to market prophets saying that the historical rules didn't apply to tech stocks in 2000 and resource stocks a year ago ended up paying a huge price.

Go on to say that chances are those investors who are taking counsel from the most extreme voices of doom today will likely pay a similar price in wrongheaded investment strategies and missed opportunities.

Your credibility with clients will be undermined if you deny that the global economy and stock markets are facing formidable challenges. In any conversation, start by acknowledging these up front.

Having done that, talk about how open markets, the spirit of innovation and the entrepreneurial ethic have demonstrated remarkable resilience in the past in working through periods that seemed at the time just as dark as the one we're in today.

A key role for financial advisors is to serve as an emotional anchor for their clients – to prevent the lows from being too low and the highs from being too high. To do that, of course, advisors themselves first have to resist the impulse to succumb to the pendulum's extremes.

We may not be all the way to the extreme of despair and pessimism, but we are almost certainly well past the mid-point. We'll look back years from now and recognize that the drastic shift in sentiment has created significant value for those bold enough to look past the swinging of the pendulum.

** Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to www.strategicimperatives.ca.*

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