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ASSET MANAGEMENT

HOW MARKET SENTIMENT CAN BE USED FOR *successful investing?*

INVESTMENT EXPERTISE – DECEMBER 2022

Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria,

the legendary fund manager Sir John Templeton once wrote.

Just as the economy is subject to constant ups and downs, the investor sentiment oscillates from greed to fear and back again. How can you avoid the most dangerous investor traps and use market sentiment for investment success?

1. WHY IT PAYS TO LOOK AT MARKET SENTIMENT

Periods of great fear and skepticism are usually marked by worsening economic data, rising interest rates or political upheavals. However, since the majority of those responsible in politics and business are not interested in permanent crises, countermeasures will sooner or later kick in if market forces alone fail to have a stabilizing effect. In other words, the panic among investors ends when the panic among politicians and central bankers begins.

Another aspect comes into play: phases of great skepticism and reluctance to buy on the market are typically accompanied by lower market valuations. Since market valuations also tend to repeatedly approach their long-term mean, valuation opportunities arise in bear markets, while valuation risks predominate at the end of bull markets. Long term investors can use this effect to their advantage by behaving counter-cyclically instead of following the herd.

2. HOW TO MEASURE SENTIMENT

Market sentiment can be determined in two different ways: first, through sentiment surveys and second, through data about the positioning of investors. The advantage of surveys is the easier availability of data, but positioning data measures the real behavior of market players in their mandates and funds.

A few examples: A frequently used indicator is the investor survey of the American Association of Individual Investors (AAII), which asks investors about their market expectations for the next 6 months („bulls“ expect rising prices, „bears“ falling prices). The ratio of bulls to bears compared to the historical average provides information on the current sentiment. The sentiment in the US media („bulls“ vs. „bears“) is regularly published by Investors Intelligence.

To be able to assess the positioning of market players, additional statistics such as net cash flows in equity funds or the hedging propensity of market players (ratio of put options to call options or „put/call ratio“) are suitable.

It is very important to look at a broad spectrum of indicators when measuring sentiment and not to give too much weight to individual, perhaps anecdotal assessments.

CONCLUSION: ACT CAUTIOUSLY, BUT NO REASON TO PANIC

The mood on the financial markets is also very poor in autumn 2022. There are many good reasons for this. The war in Ukraine, high inflation, rising central bank interest rates and concerns about aggressive Chinese policies have clouded the immediate business outlook for many companies. However, stock market history has taught that in an environment of great skepticism and lowered market valuations, while no automatic buy signal is given, at least panic selling of equity positions is less advisable. Many equities are already trading at historically below-average valuation levels, but this is not yet the case for other market segments.

Therefore, when selecting individual stocks, it is also important to pay attention to which stocks are already pricing in a very negative scenario and for which this is not yet the case.