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Psychology of Investing and the Cycle of Emotions

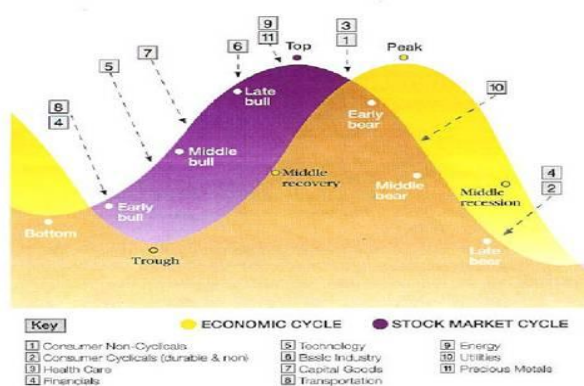
Psychology of Investing and the Cycle of Emotions

We all know that life, business and the economy experience the ebb and flow of cycles and the seasonality of change. Each can be said to cause and affect the other.

From Chart 1 (Business Cycle and Relative Stock Performance), we see that the financial market (stock market) usually leads the real economy in downturns as well as in recovery. It also shows that different sectors (1-11) do better at different stages of the economic cycle.

Similarly, investor behavior is affected by what's happening in financial markets (the least tangible assets such as stocks, bonds and currencies) as well as what's happening in companies of the real economy. Factors such as economic fundamentals, valuations and technical analysis affect the financial market but investor sentiment and psychology play a significant role.

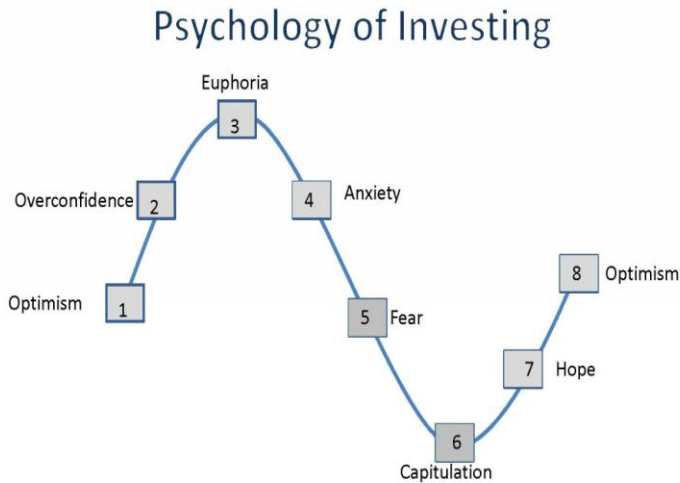
Business Cycle and Relative Stock Performance



Source: Stavill, Sam. *The S&P Guide to Sector Investing*. New York: McGraw-Hill, 1995.

In the Cycle of Market Emotions (Chart 2), the investor's emotional cycle is described as passing through eight stages, in tandem with the performance of the stock market.

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Stage 1 - Optimism - This stage often occurs in the middle of an economic recovery. The Stock Market is on the rise, the economy is growing or expanding, interest rates are relatively low, inflation is low, unemployment is low, consumers are spending, the government seems to be in control, and the country is considered politically stable.

At the business level, more companies are profitable, corporate failures and bankruptcies are low, labor is tight and the business outlook is generally rosy. Businesses are ready to take on more leverage for expansion by acquiring new equipment and manpower.

The Investor is holding down a stable job or running a successful business, and may be looking to buy a new car or house, or to invest.

As a result of increasing consumer spending and new business expansion, the economy responds positively. Financial asset values change. While previously based on intrinsic

value, value is now based on market perception and market consensus.

Stage 2 - Overconfidence - The Stock Market advances higher. The collective consensus is that good times will last forever.

The banking and economic system, now flush with easy credit and liquidity, hurries to put new money to work, apparently convinced that the underlying bullish trend is going to last. Investor appetite for risk increases as they seek growth.

Stage 3 - Euphoria - The Stock Market advances even higher, delivering as promised in terms of growth and continuation of the uptrend. Investors are thrilled by the speed of the market rise, and their own rising net worth. The Stock Market reaches new all-time-highs. The market is bubbling up and waits for nobody.

This is probably the most exciting phase of all. Investors are drawn to the market rise and many feel compelled to buy something at any price. It is the point of maximum risk, with speculation replacing rational thought. The party is on, the music is playing, everyone is having a good time and nobody wants to be the party pooper.

Stage 4 - Anxiety - The Stock Market dips. The party comes to an end and the music stops. The beginning of the end of an upward trend is always a point of great anxiety.

Buyers and sellers are confused and uncertain. Buyers feel remorse over buying at record high prices. Sellers are uncertain because they are in the minority camp, selling against a powerful trend. The weakness in the market could be a mere

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correction, in which case, selling out would be a wrong decision. But if it's the new beginning of a downtrend, the best decision is to get out quickly. In fact, one might even contemplate short-selling at this stage.

Stage 5 - Fear - The Stock Market breaks out from a consolidation and turns downward. It takes a step up and two steps forward (down) as the downtrend continues.

When the Stock Market starts to turn down, a correction of 10-20% is the norm. However, from time to time as in the last decade, we've had corrections that go beyond 50%. This is referred to as a major bear market. In the case of the current major bear market, the battle of the buyers (bulls) and sellers (bears) is now over, having turned decisively in the direction of the sellers (bears). Those holding out their long positions are hoping for recovery in the market. Hope and patience become the virtues needed to ride out this period.

In a truly major bear market, hope turns into fear. At this stage, the news media publishes more negative news on the economy, weakening the Investor's own resolve, faith and conviction. Feeling fearful at this stage is normal when one's net worth has declined significantly. Many investors sell at this stage as their aversion to risk and the need to take action grow. Others may be prepared to stick it out.

Stage 6 - Capitulation - This is the most intense selling part of the bear market. As mass selling gains momentum, it may seem that everyone is selling at any price. At this stage even the most stolid Investors may wonder why they haven't liquidated their positions like everyone else. The stock market declines to new lows and the decline is now long and deep. Reasons for the bear

market are widely publicized. There is a "herd mentality" in the market place and selling pressure gains momentum as many are still trying to get out of the market.

By now, the reasons for the major bear market have become common knowledge. Fear becomes desperation as the market decline gathers speed and losses mount. Investors second-guess their portfolio risk tolerance, as risk management and capital preservation become a major consideration.

While emotion may be saying one thing, **capitulation is the point at which objective and successful investors start buying.**

When we are near the point of maximum market decline, instead of starting to buy, many investors have lost faith in the financial system and the investment world. Investors are pre-occupied with wealth preservation and safety. This is usually the point of maximum financial opportunity for those brave enough to buy and be a market contrarian.

Stage 7 - Hope - The Stock Market breaks out of the declining trend. Just like a spring coil that has been depressed for a long time and cannot go down anymore, the market springs back to life. All investors wishing to sell have already done so, and the only way to go is up. Investors are more hopeful and ready to start buying.

While economic activity improves at the margin, people have been hurt and many are skeptical. As a result, many asset classes are still under-priced and may be poised for a comeback.

The economy and financial markets have finally come around and might have even

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turned the corner. Many signs of stability are emerging and recession seems to be over. Investor portfolios are looking healthier.

Stage 8 - Back to Optimism – Back where we began. Maybe the good times can last forever! Like a roller coaster ride, we have experienced the heights of irrational exuberance and the depths of despair only to find ourselves back in the same state of mind. Have we learned anything?

Conclusion

Let's hope we're better prepared for the Market's next emotional ride. By understanding the stages of markets and investor emotion, we do better each time at getting through the Bear Markets. Many investors have learned the hard way that markets are not on an endless upward trajectory; successful investment strategy requires that investors be pro-active, flexible, and have the courage to seize opportunity.

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