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Lifelong lessons from the master investor

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Investors are never short of advice. But it's good advice that matters. From long experience I've found we learn most from the highly successful investors whose egos are small and who can express their insights as memorable maxims.

The late John Templeton, a pioneer of mutual funds and international investing, fitted those criteria perfectly. Here are four of the guidelines he set out for us:

- "'This time is different' are among the most costly four words in market history."
- "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria."
- "If you are diversified among different forms of wealth, nations and industries, you'll be safe in the long-run."
- "Successful investing is only common sense."

In my thinking, common sense in investment decisions is even more important now than in John Templeton's day. That's because today's communications, the growth of derivatives, the importance of hedge funds, program trading and short-selling all combine to add to volatility and the tendency of markets to adopt extreme positions.

Either the investment outlook is seen as all positive or (more often) the dominant view is that a crisis is developing and markets are about to crash. Shades of grey are given little attention in market sentiment — or simply ignored. Yet it's awareness of them that can help identify attractive investment opportunities, particularly for when the prevailing market sentiment moves on from its extreme view.

Here are some examples where investor sentiment didn't (or at present doesn't) allow enough for shades of grey:

1. China.

In recent years, market views on China have been extremely pessimistic. China's contradictory economic system (increasingly capitalistic but with a one-party, communist government), the excess capacity that's built up in heavy industries, the inequalities and the rising level of debts have fed expectations China was on course for a hard landing and then a long period of economic stagnation.

In late 2015 and early 2016, many global investors and commentators misread Chinese data (particularly the closely watched purchasing managers' indexes for manufacturing and the monthly estimates of international reserves). Little attention was given to growth in consumer spending and in the services sector or the scope China had to ease its fiscal and monetary settings or to speed up its program of urbanisation.

Since late February, it's been clear that, while the Chinese economy has slowed, economic crisis has been avoided. The earlier assessment, "sell everything to do with China", cost many clients of hedge funds a lot money in the March quarter.

Common sense also suggests that the trend growth rate in China has declined and will move lower — maybe to an average growth rate of 3-4 per cent a year — by the mid 2020s.

The main reason, of course, is the Chinese economy is larger (in 2016, China's GDP is 2.75 times bigger than it was in 2000).

Even the scaled-down trend rate of growth I've mentioned will provide opportunities for the Australian economy and many businesses here.

2. The US.

Many investors fear the US economy, which has averaged growth of 2.25 per cent a year since 2009, is slipping back towards "stall speed" and the US will experience secular stagnation.

Their concerns are based on the failures of consumer spending and business investment to respond as much as they did in earlier cycles to influences such as low interest rates and the rebound in asset prices.

Again, it's useful to look at the whole picture. The growth of jobs in the US is impressive. Spending on house construction and motor vehicle is strong. US households have cut back on their debts. US companies are, in aggregate, cashed up. Inventories are under control. Prospects are the US economic upswing that's been running since 2009 isn't about to end.

3. Inflation.

With 10-year government bonds yielding 1.8, 0.2 and negative 0.1 per cent in the US, Germany and Japan respectively, bond investors are confident inflation will be negligible for a very long period.

I'd suggest a common sense view that global inflation will remain slight for another year or two — though not necessarily as low as bond markets are currently pricing — but then move up cyclically, as energy prices rise and wages increase in response to tightening labour markets. The risks of a cyclical recovery in global inflation will be heightened if governments and central banks maintain their highly accommodative policies for too long — and as some of the enlarged money balances created by the major central banks start circulating.

4. Exchange rates.

So far this year, the Australian dollar has mostly traded at higher levels against the US dollar than had been expected. That's because the Chinese economy didn't contract as the consensus view had anticipated, the US dollar softened against other major currencies, and until last week the Reserve Bank held off cutting the Australian cash rate.

Maybe, when all the influences on the Australian dollar are allowed for, the expectation should be that the Australian dollar will move down somewhat further over the next 12 months as the US dollar resumes its upward trend. But the further downside in the Australian dollar may well be less than many people in business are still hoping for.

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