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Book Review: Mastering the Market Cycle

Howard Marks is a highly regarded value investment manager, with his previous book on investing, The Most Important Thing, becoming an acclaimed bestseller. He co-founded Oaktree Capital Management in the United States, and started his first fund in 1988, investing successfully in the (then-young) junk bond market.

As the title implies, his latest book aims to explain factors that impact and drive the ups and downs of financial markets, such as economic cycles, interest rate cycles, company cycles and, importantly, investor psychology. He uses real-life examples to make it easy for his readers. Why is this so important? Marks believes that the ability to identify and understand these cycles is one of the most important ways to find opportunities to make extra profits and/or avoid losses in a portfolio by “getting the odds on your side”.

Prudential clients may wonder why we would commend Marks’ idea of Mastering the Market Cycle, since it seems to imply forecasting, something we reject in our own investment views. However, Marks

does not believe in forecasting, especially the tops and bottoms of market cycles – in fact he acknowledges it's impossible – but rather in trying to understand cycles and spot certain warning signals that tend to recur to give you an idea of where you are in a cycle. When you can recognise that conditions are getting extremely positive versus the fundamentals, you can avoid any possible coming bust by adjusting your portfolios more conservatively, or make additional profits by investing more when conditions appear to be exceptionally negative.

Of course you can never know exactly when to stay in or pull out, but even just being on the "right" side of the cycle can add performance to a portfolio. This can be done, Marks says, by paying attention to information one sees every day and inferring where investors' "pendulum of psychology" may be sitting on the path between extreme bullishness and extreme bearishness.

Although Marks himself has experienced 48 years' worth of market cycles, he acknowledges that they are exceptionally unpredictable and variable due to the involvement of humans: investors' short-term emotions and psychology play a large role in driving cycles and in the extreme overshooting and undershooting of prices away from their long-term midpoint (or mean, or "fair value") as reflected by underlying fundamentals. In fact, he notes, markets spend very little time priced at their long-term fair value, and much more time moving either toward it or away from it, and back again.

As valuation-driven investors ourselves, we would broadly agree with Marks' analysis. We similarly attempt to understand the extent to which current fundamentals are driving market moves versus the daily news and/or investor risk sentiment. This informs our asset allocation views, while our stock selection process also aims to understand companies in the context of broad cycles in profits, costs, margins, competitive position, and so on.

Reading Marks' book would benefit anyone interested in learning more about how and why markets move, to possibly tilt the investment odds in their favour.