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Most investors are now intent on recovering the money they lost in the bubble, but this pursuit must be realistic, and it could take years

What we learned and what we should expect now

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The crash of 2008 hit most people like a firestorm. Few saw it coming. Of those that say they did, apparently most did not take defensive action to protect the capital under their control from life-altering damage.

Deeply mired in "long-always" thinking, the investment world carelessly shovelled billions into the inferno of a market peak. The math of loss is unkind. Price declines in the order of 50-70 per cent will now need years, and in some cases decades, to recover the levels seen near the 2007 cycle peak.

Psychological damage from the economic downturn has been epidemic among professionals and lay people alike. Demand for anxiety medication is up. Many now suffer post-traumatic-stress-like symptoms, and rather than objectively hunting for attractive investment opportunities, a large number of financial professionals are now engrossed daily in fending off lawsuits, rethinking their careers, revisiting an interest in God, religion and the meaning of life. This is typical of what happens to investor sentiment after lengthy bear markets. The consistency of our behavior and thinking is what makes it a useful contrarian indicator.

None of this is new. It is classically human. Through my blog, I receive reader mail daily from those who have lost heavily and are now feeling lost and depressed: "I am sickened by my losses," says one writer. "I have not been able to sleep well in many months," says another. "I am revolted by the financial industry and its adviser 'salesmen' who sold me a bill of goods and left me to pay a heavy price," writes another. "I feel like a fool. I feel betrayed. I feel mad. I feel embarrassed." And most common of all lately, I hear this: "How can I get my losses back?"

A desire to make back one's losses is understandable. But investing with this motivation is inherently dangerous — more likely to compound, rather than recoup, losses. There is desperation in this thinking. Desperation is the arch enemy of reasoned and objective investment policy.

Investment strategy must be designed with a responsible risk exposure for a given person, account and market environment. We cannot force markets to give us what we demand. The first step is to acknowledge past mistakes, the behavior and strategies that took one down the wrong path.

Next, we must understand, once financial bubbles burst, it is typical that price peaks in affected areas do not return for years, decades or sometimes longer.

Today we are cleaning up the mess of coincident financial bubbles, which ballooned and burst across the world, from real estate to credit, corporate bonds to equities, commodities to currencies, antiques to collectors' art.

Few things in the world escaped overinflation caused by the 2004-2007 spending spree. Those who are now hoping for a quick reinflation of consumer spending and prices to bubble-levels are sorely missing the lessons of history. A study of the semiconductor sector over the past 10 years is instructive.

World demand for semiconductors did not end in 2000. It has been growing ever since. A recent KPMG report estimates that global semiconductor sales will reach $260 billion in 2009, up from $213 billion in 2004. Although very cyclical, the 20-year average annual growth rate for this sector has been 13 per cent. Yet the aftermath of the 2000 tech bubble was not kind to semiconductor investors. After a bubble peak of $105 a share in 2000, the semiconductor index (SMH) deflated more than 80 per cent into late 2002. It recovered 130 per cent from 2002-2004 (see box in SMH chart above) and then dropped 57 per cent to $15 a share in the bear market of 2008.

From current levels it is probable that this index could climb back to the $35 area again in the next cyclical expansion. Returns of 130 per cent are excellent over a four-five-year market cycle — but only if we buy low and then sell again to capture the gains. For those who held and did not sell near the peaks of 2000 and 2007, reclaiming $35 a few years from now, will amount to negative real returns for years of heart-thumping holding in this "growth" sector. Charts of copper and oil suggest similar stories about the recovery prospects for many commodity prices from here.

Starting from 67 cents a pound in 2002, copper rocketed to an incredible $4 a pound in the speculative bubble of 2006-2008 before collapsing 69 per cent to $1.25 in 2008. Even in a muted economic recovery, on-going demand for copper is likely to see some growth. A price gain of 100 per cent to $2.50 a pound would be within reason over the coming expansion and yet would be of little comfort to those hoping for a move back to bubble prices.

Pegging our hopes to past bubble peaks is most likely to cause further frustration and financial pain. It will also make us more susceptible to overholding risk assets again in the next expansion. Even if asset prices succeed in making very respectable gains over the next few years (and we think it's likely), those trying to reclaim bubble levels are likely to be impatient, desperately aggressive and emotionally geared to suffer heavily again in the next cyclical bear.

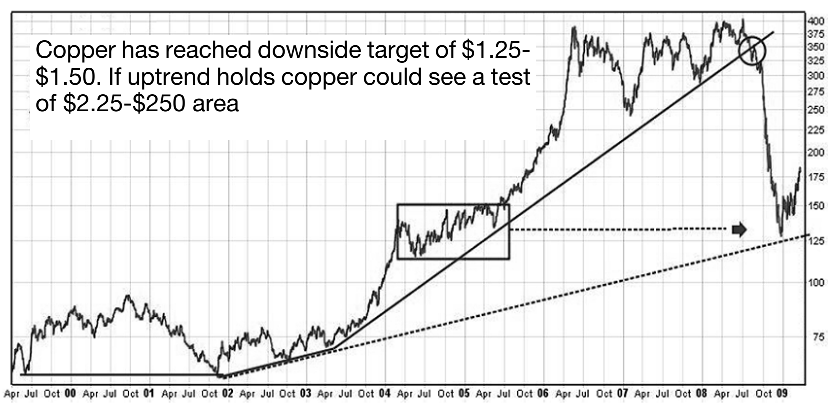
Oil demand has softened significantly over the past year, but at this point at least, the world is still reliant on oil. From the bubble peak of $147 a barrel West Texas Intermediate crude contracted to US$35 or 76 per cent. It is possible that the next cyclical expansion could take oil prices back to the $60-$80 a barrel range. This would be a strong appreciation from present levels. However, those hoping for the bubble peak to return may be waiting a long time.

DID THE WORLD STOP USING SEMICONDUCTORS IN 2000?

Alternative energy

The passion for domestic, greener power is gaining momentum. The alternative energy genie is not likely to slip back into the bottle any time soon. Finding alternatives to foreign oil has become the first stated goal of the Obama administration. While some find time for endless debate about theories of climate change, we find this to be the pastime of navel gazers and tire kickers.

COPPER BUBBLE PEAK WAS $4 A POUND



Whatever one's beliefs on global warming, there can be no credible argument for continuing to send billions of western dollars into the coffers of foreign oil producers when there are countless more efficient domestic technologies (and jobs) available for development at home.

Couple this with the recent urge to keep U.S. spending in the U.S. and we believe we have a seismic shift in American energy policy.

While oil has been the dominant global theme of the past 100 years, it seems obvious that cleaner-energy and clean-water management will increasingly become the dominant themes of our century and beyond. There are many substitutes we can develop for oil. There are none for water. Anyone who disagrees that water is more valuable than oil should be invited to take the age-old taste test and drink a nice big glass of each!

OIL — BUBBLE PEAK WASD US$147 A BARREL

So far, governments have been hopelessly myopic on this key issue, foolishly endorsing energy projects like the Canadian tar-sands that consume three barrels of water for each barrel of oil produced. Eventually the madness of such propositions will be proclaimed in the main.

Lessons learned

As airlines instruct us, it is important to plan exit routes before our plane takes off. The right question from here is not "How can I make my losses back?" but rather "How can I avoid suffering large losses the next time?" The market recovery will come, and gains will follow. And then there will be another bear. Knowing our exit strategy in advance is the key to lasting success.

Investors that take the time to objectively define conservative asset-allocation limits, as well as their buy and sell rules for risk assets, are less likely to succumb to overholding and the next bubble mania. The happy outcome from financial pain is always the same. Those who use the experience to change their behavior and approach can profit from it for the rest of their lives.

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