Your Wealth Bulletin

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Hi,

This month we examine:

- The significant rise of the $A and failure of forecasting
- The science of neuroeconomics

Rise of the Aussie Dollar

Where to next?

The Australian dollar's recent dizzying ascent to levels above 90 US cents has attracted much analysis in the financial press from commentators who say this was always on the cards.

A weakening US dollar and the widening interest rate gap between Australia and the United States, together with Australia's leverage to the commodity price boom, are all cited as underpinning this extraordinary rally.

According to one article, the 23-year highs for the $A are seen as merely a pit stop on the way to parity with the greenback. As a result, a host of banks have been upgrading their forecasts for the local currency. So it's interesting amid all this after-the-fact market wisdom to look at what these same analysts were saying at the start of this year.

According to a Reuters poll in January of currency analysts with the major domestic and international banks, the Australian dollar would be around 78 US cents by July this year and at 76 cents by early 2008. In other words, the currency has overshot market forecasts by 22 per cent.

Bear in mind that those making these forecasts are paid to do just that. In fact, for some of them, that's all they do - pore over charts and spreadsheets and forecast currencies and interest rates.

One strategist from a major European bank was quoted in the Reuters poll as saying that commodity currencies like the Aussie dollar could come under severe pressure by the end of this year as the global economy faltered.

Even the more bullish forecasters in the poll saw the $A only scraping the 79 US cent mark by the end of 2007.

Remember the Aussie dollar's five-year descent to around 48 US cents early this decade? During that period, analysts were frequently quoted talking about "fair value" of around 65 US cents and complained about over-shooting.

They are employed to do that because so much rides on these variables for many of the banks' big clients- for exporters, for importers, for stock investors, for global borrowers and lenders and for the banks themselves.

But more often than not, they get it wrong. And not just a little bit wrong, but horribly wrong, both on the way up and on the way down.

Now with momentum going in the other direction, they are saying that we are merely on a pit stop to a parity party.

Maybe we are. Maybe we aren't. The truth is nobody really knows.

Neuroeconomics

Taking emotion into account

Jason Zweig, a senior writer for US Money magazine, is the author of a new book called, 'Your Money & Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich'.

In an interview with the Index Universe.com website, Jason outlines some interesting facts about this developing science.

When questioned about investors reaction to volatility, he answers, "Very few people have the ability to buy a stock, vault it away in their portfolio and leave it until it makes them wealthy. I think there's a reason for that: The brain is not really very well-suited for that kind of behavior. Most people will buy more when something goes up and either sell it or freeze when it goes down."

"The brain has been built to make basic decisions about risk and reward. We don't have financial circuitry in the brain. When you make a decision about risk and losing money, that's handled by the same kind of circuitry that responds when you face physical risk and mortal danger. There's not much difference in the brain between having a rattlesnake slither across your living room carpet and having some stock you own go down 40 or 50 percent. Basically it's the same response, "I'm in trouble; how do I get out of here alive?" It's very fast. It's incredibly rapid."

In the interview, Zweig continues to discuss that it is well known human behaviour that we often do something, even though we are not rationally aware of what we are doing.

Zweig comments further, "For example, if you're watching CNBC and the market is plunging and Jim Cramer is throwing furniture and biting the heads off live chickens, you may be sort of watching it saying, "Oh wow, something really bad is happening; the market is crashing." But while you're watching it your palms are sweating, your breath is coming fast, your pulse is racing, your muscles are tensing, your entire body is on red alert. You're intensely upset by what's happening in front of you, but the thinking part of your brain is so busy trying to make sense of it that it's not aware of what the emotional part of your brain is experiencing. And if in that moment you are suddenly called on to make a choice, "Should I sell this stock or should I hold it?" ...

" If you're making that choice at that moment while Jim Cramer is screaming in your face, you will not buy and it's highly unlikely that you'll hold ... because all of that screaming, all the red, all the downward pointing lines are so upsetting that you will make a negative decision, even if you're not aware at that moment of how upset you are."

" The flip side of this is unconscious bias. Just as you can have a feeling that you're not aware of having, you also can have preferences that you don't realize you have."

" The simplest example is what psychologists call "implicit egotism," which is a really bad term for liking whatever is closest to you in some way or another. For example, people are 65% more likely to marry someone whose surname begins with the same initials as their own. When you tell people something like this, they tell you that's ridiculous, and how do they try to disprove it? They say something like, "Well, my name's Zweig and my last name begins with a "Z" and my wife's surname doesn't begin with a Z." That doesn't work."

" Psychologists have looked at hundreds of thousands of data points and demonstrated very clearly that this is true, and that people named Dennis and Denise are much more likely to become dentists then you would expect by random chance. People named George are more likely to become a geoscientist then you would expect by chance alone. We all come with these strange, unconsciousness preferences. We don't think we think that way, but we do."

For do-it-yourself investors that aim to trade stocks regularly, these weird and unconcious trains of thought are likely to have a dramatic impact upon their portfolio.

Given that there are so many biases and unconcious effects upon investment decisions, Zweig confirms that for the long term investor, there is an available method to avoid the making of irrational or erroneous decisions.

Zweig concludes, "One thing that people who buy index funds can take a lot of comfort in, is that by definition, an index fund should not be influenced by unconscious bias, and overall, that should be a good thing over the long run."

Click here for Jason Zweig interview

If you have any queries about this month's newsletter or would like to discuss your financial situation in more detail, please feel free to email or call our office on (02) 9525-0777. If you would like to forward this email to a friend, click on the forward email link below.

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