Thesis Market Commentary

April 2017

"The investor's chief problem – and even his worst enemy – is likely to be himself." – Benjamin Graham

Traditional finance is based on rational and logical theories, such as the capital asset pricing model (a model that describes the relationship between market risk and expected return for assets) and the efficient market hypothesis (a theory in financial economics that states that an asset's price fully reflects all available information). These theories assume that investors are rational, which means they make decisions that maximise utility and revise their expectations in a manner consistent with Bayes' formula (updated probabilities based on new information). In addition, it is assumed that investors are both self-interested and risk-averse.

Behavioural finance on the other hand is focused on explaining why market participants make irrational systematic errors contrary to the assumption of rational market participants. In other words, behavioural finance differs from traditional finance in that it focuses on how investors and markets behave in practice rather than in theory. Research in psychology has documented a range of decision-making behaviours called biases. These biases affect all types of investors, both private and professional. But by having an understanding of them and their effects, we may be able to reduce their influence and learn to work around them.

Behavioural biases - cognitive errors and emotional biases

Behavioural biases can be categorised as cognitive errors or emotional biases. Cognitive errors are glitches in our thinking that cause us to make questionable decisions and reach erroneous conclusions. They can also be thought of as blind spots but by clearly identifying the bias, one can easily moderate and correct a cognitive error. Emotional biases however relate to feelings, perceptions, or beliefs that may or may not be reality-formed: this bias is much more difficult to control. Many researchers therefore believe we cannot moderate emotional biases but instead must adapt to them.

Cognitive errors

We classify cognitive errors in two categories. The first contains "belief perseverance" biases. These biases suggest when faced with evidence that contradicts our beliefs, we choose to discredit, dismiss, misinterpret, or place little significance on the contradictory information. From an investment perspective we should be aware of biases such as conservatism, confirmation, representativeness, illusion of control, and hindsight.

Example – confirmation bias

Investors exhibiting a confirmation bias have a tendency to search for, interpret, favour, and recall information in a way that confirms their existing opinions and ignore (or tend to discount) information that contradicts or could change their beliefs. The result is a one-sided view of the situation and helps explain why bulls tend to remain bullish and bears tend to remain bearish regardless of what is actually happening in the market. Placing excessive weight on confirmatory information after making an investment decision and tending to ignore or modify contradictory information can lead to poor financial decision-making.

Recommended solution

We need to be aware that a confirmation bias is common among all investors. Making a deliberate effort to gather and process both positive and negative data will help form better decisions and help moderate the bias.

The second category of cognitive errors deals with "processing errors" relating to the misusing and the irrational or wrongful processing of information to make decisions. The main processing errors here are anchoring and adjustment, mental accounting, framing, and availability.

Example – anchoring bias

The concept of anchoring draws upon the tendency for us to attach or "anchor" our thoughts around a reference point despite the fact that it may not have any logical relevance to the decision at hand. Investors influenced by this bias often become fixated on a particular level or round number such as gold

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trading at $1000 or oil at $50. This is also true in relation to setting target prices or determining the economic condition of a country, even if the investing landscape has shifted or new information is available. This irrational processing of information often leads to inappropriate investment decisions.

Recommended solution

We should question whether we are giving undue weight to an entry point, or some other state that has become the anchor. We should also remind ourselves that historical prices, market performance, and previous reputation have little if no correlation with future investment potential.

Emotional biases

Emotional biases are much harder to control because they originate from unconscious influences rather than conscious calculation (as in cognitive errors). For that reason it may only be possible to recognise the bias and adapt to it rather than correct for it. Emotions biases are rarely identified and recorded in the decision-making process so fewer biases have been identified, but the noteworthy biases are loss aversion, overconfidence, self-control, status quo, endowment, and regret aversion.

Example – regret aversion bias

When we resist taking action due to fear of bad outcomes we usually suffer a regret aversion bias. This tendency is especially prevalent in investment decision-making and stems from the desire to avoid feeling responsible for poor results. Regret bias has two dimensions that arise through errors of omission (failure to act) or errors of commission (an act). It's the regret from actions taken that generally create stronger feelings which results in a lack of action as the default position. If the investor does engage in financial markets it's likely to result in herding behaviour as they feel safer in popular investments. If the investment does turn out wrong, they can at least console themselves in that they were not the only one who got it wrong!

Recommended solution

In overcoming regret aversion investors must come to terms with the fact that losses happen to everyone, and that the long-term outcome should not be sacrificed to follow the current trend. Investors need to acknowledge the risk-reducing and return-enhancing advantages of diversification and the benefits of an appropriate asset allocation.

Conclusion

Behavioural finance holds out the prospect of a better understanding of financial market behaviour and scope for investors to make better investment decisions based on an understanding of the potential pitfalls. We cannot cure the biases, but we can attempt to mitigate their effects. Using techniques such as feedback, audit trails for decisions, checklists, and 'devil's advocates' can help us make decisions in a more rational manner. We need to avoid the costly errors stemming from a quest for comfort that capital markets rarely reward and by maintaining our discipline and staying committed to our long-term strategy, we improve the chances of investment success.

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News and views

The Trump-inspired equity rally lost some steam in March as the failure to deliver on his campaign promise to replace the Affordable Care Act raised concerns about the US administration's ability to successfully push through ambitious tax reform, deregulation and infrastructure spending policies. Nonetheless European and emerging equity markets picked up the baton to deliver strong gains as investors rotated positions into cheaper equity markets as better than expected macroeconomic data improved the outlook. March also saw the US Federal Reserve hike rates, France catch election fever and the UK trigger the start of Brexit negotiations.

Indices	Value as at 31/03/2017	% change on month	% change year to date	% change on 12 months
FTSE 100 Share	7322.92	0.82%	2.52%	18.59%
FTSE All Share	3990.00	0.93%	3.02%	17.52%
S&P 500	2362.72	-0.04%	5.53%	14.71%
Dow Jones	20663.22	-0.72%	4.56%	16.84%
Euro Stoxx 50 EUR	3500.93	5.46%	6.39%	16.51%
Nikkei 225	18909.26	-1.10%	-1.07%	12.83%
MSCI Emerging Markets	958.37	2.35%	11.15%	14.53%
UK Treasury 1.25% 07/22/26	103.79	0.00%	1.39%	4.17%
Sterling/US$	1.25	1.01%	1.97%	-12.87%
Sterling/Euro	1.17	0.16%	0.21%	-7.30%

Source: Bloomberg

US

It was little surprise that Fed officials stuck to the script and delivered on an interest rate increase on 15 March following their pre-meeting communications campaign. Of greater significance was the lack of change to their economic projections. This suggests the Fed merely viewed March as an opportune moment to continue along its prescribed path, as opposed to a faster hiking sequence pointing to a new sense of urgency to normalise rates. In economic news, data released by the US Commerce Department showed that US real GDP for the fourth quarter of 2016 was slightly revised up, from a previous reading of 1.9% to an estimate-beating annual rate of 2.1%.

Europe

Polls immediately following the French presidential debate on 20 March gave centrist candidate Emmanuel Macron a convincing lead, sending the euro higher amid easing concern that anti-EU candidate Marine Le Pen could triumph. While the likelihood of a Front National victory in the second round appears small the consequences would be substantial. Despite the media's unwavering focus on European politics, the eurozone economy continued to come out with solid data points and beat expectations. The strength of economic indicators has prompted investors to revise up their expectations for earnings growth. This has set in motion flows returning to European equity markets, which appear to be gathering pace. The growth-inflation dilemma however remains unresolved with the European Central Bank (ECB) wedged uncomfortably between improving growth prospects and sticky, lacklustre underlying inflation conditions.

UK

The Bank of England (BoE) kept UK interest rates unchanged at 0.25%, although Monetary Policy Committee (MPC) member Kristin Forbes expressed concern about inflation, and voted to raise rates. UK inflation rose to 2.3% in February, breaking the BoE's 2% target for the first time in over three years. The triggering of Article 50 into month-end was a political milestone that brings the UK one step closer to actually leaving the EU but was well-flagged and met with a muted response in financial markets. Mirroring the relative calm in markets, the latest survey data suggested that consumers, the mainstay of growth last year, are also fairly sanguine about the effects of Brexit.

Emerging

Emerging equity markets gained further ground in March led by India. Voters in India's most populous state of Uttar Pradesh delivered a decisive victory to Prime Minister Modi and his Bharatiya Janata Party in March. The win is likely to give a much-needed boost to business sentiment and strengthen the government's resolve to push through its pro-poor, pro-market and anti-corruption reforms.

The Chinese government lowered the 2017 growth target to 6.5%, as it endeavours to reduce overcapacity, deleverage the corporate sector and destock the housing market. The People's Bank of China continues to be faced with a choice between raising rates more aggressively - adding stress for indebted corporates - or accepting more pressure for yuan depreciation and capital outflows. It decided to tighten monetary conditions by increasing the market-based policy rates for the second time this year. Equity markets made gains reflecting solid economic data and fewer concerns surrounding capital outflows following better-than-expected foreign exchange reserve figures.

Japan

Japanese data has been reasonably positive, with business surveys indicating expansion and falling unemployment, now down to only 2.8%. However, confidence in the US administration's ability to stimulate growth and the strength in the yen continue to weigh on the performance of Japanese equities.

Fixed interest

March was a mixed month for bond markets. In general, bond yields (which move inversely to bond prices) rose during the first two weeks, before then falling in the second half of the month. Interest rates had moved up ahead of the actual Fed rate hike and the market corrected this over-reaction based on future anticipation of the Fed being less aggressive going forward.

An update on some of our favoured stocks

Prudential

For the long-term growth that Pru offers and the quality of the group's earnings and balance sheet, we think it comes at a very reasonable price. Earnings are geographically diverse with an even split between its UK, US and Asia businesses. The UK business remains very cash generative but with the implementation of Solvency II and increase in capital requirements in the UK, Pru made a strategic decision to retreat from these capital-heavy products, predominantly annuities. We think this makes sense given it wasn't the most efficient use of capital as it had more attractive businesses in Asia and US generating higher returns on capital. Prudential has a very strong franchise in Asia spread across the continent which represents a significant and growing proportion of its business. We think one of the bigger concerns hanging over the share price recently has been the group's increasing reliance on Hong Kong sales growth – and within this the uncertain outlook for 'offshore' sales (new regulations in China that would prohibit customers from the mainland buying insurance products in Hong Kong). Management has gone a long way to alleviate apprehensions surrounding this issue by mentioning around 80% of the mainland customers who buy products in Hong Kong have bank accounts there and that the majority of new business premiums are now being paid via HK bank accounts. On top of this the results provided evidence that Pru's managing this process rather well, with an acceleration of sales growth in Asian operations outside Hong Kong.

Carnival

Carnival has reported a strong start to year and given an encouraging outlook, with bookings up and at much higher prices, with less supply remaining for 2017. Consequently, Carnival has raised full year revenue yield guidance to between +2.5% and 3.5% (from approx. 2.5% previously), whilst cost inflation remains unchanged with some modest positive FX/fuel price moves. The net effect is an increase in earnings per share guidance by 10c to $3.50-3.70 (from $3.40-3.60 previously). With less inventory left to sell we expect further upward pressure on yields as the peak summer travel season approaches. The solid demand and pricing trends look well supported in the current environment as leisure travel continues to recover aided by macro tailwinds and opportunities arising in China and Cuba. It's shaping up to be a great year for Carnival and we expect continued progress as the year unfolds.

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