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MARKET INSIGHTS

EXPLOITING BEHAVIOURAL BIASES: DRIVERS BEHIND TODAY'S QUALITY BUBBLE

JULY 2014

EXTREME VALUATION GAP

Emerging markets appear to be witnessing a mispricing episode. Equity market investors are paying an ever higher price for defensive and quality stocks at the expense of cyclical names. As a result, the valuation gap between popular stocks and out-of-favour stocks is approaching levels seen in prior bubble episodes. Such episodes occur when prices over- or under-shoot beyond the level justified by fundamentals.

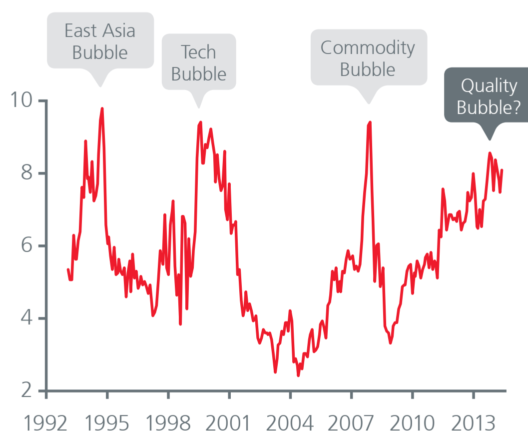
The current episode provides a section of popular but extremely expensive stocks as well as a long tail of deeply discounted companies. As value investors, the latter is the unloved section of the market we research for potential future outperformers. The key to successful value investing is remaining true to a disciplined investment process and avoiding the behavioural biases that repeatedly give rise to such bubbles.

Following a period of significant underperformance, emerging markets trade at a material discount relative to their own history[1]. Beyond the depressed headline valuation, however, a deeper stock-level disparity is opening.

Figure 1 illustrates the spread between the price-to-book ratio of the most expensive quintile and cheapest quintile of large stocks in emerging markets. This is a useful indicator for the price gap between popular and out-of-favour stocks. The current gap is approaching levels last seen in prior bubble episodes, such as the Tech Bubble in 2000 and the Commodity Bull Cycle in 2007-2008.

Expensive stocks are approaching bubble territory: expect mean reversion.

Fig.1. Price-to-book (x) spread between the cheapest and most expensive stocks in emerging markets[2]



Source: Bank of America Merrill Lynch Global Research, Factset, as at 30 June 2014.

[1]The MSCI Emerging Markets index is approximately 1 standard deviation below its 10-year historical average Price-to-Book ratio, as of 31 May 2014. [2]Based on 150 biggest companies in the emerging market universe. Spread between most expensive and cheapest quintile median price-to-book ratio.

FALSE ASSUMPTIONS

Coming to grips with how investors form beliefs can shed light on the current mispricing episode. Investors often implicitly assume that share price movements are a linear function of company fundamentals plus new information. Active investment management often assumes that there is a stable relationship between a company's fundamentals and share price.

Under this model, fundamental investors compete to have superior information gathering and forecasting abilities. If prices respond in a predictable way to new information about changes in company fundamentals, the investor with the best information or most accurate forecasts has an edge.

In reality, this assumption does not always hold up. There is a large body of evidence to suggest that investment approaches based on superior information gathering and forecasting are not successful as they run into the following problems:

- Changes in price are more volatile than changes in the underlying fundamentals[3]
- It is extremely difficult to consistently and accurately forecast market movements[4]

In sum, the market's price determination mechanism is far more complex than is accepted by industry convention. While we believe the ultimate driver of share prices is corporate financial performance, over shorter periods of time, market prices can over- and under-shoot. Exploiting these pricing episodes allows us to capture maximum impact opportunities.

BEHAVIOURAL BIASES INFLUENCE PRICES

Hard-wired human behaviour is partly to blame for share price movements that are more dramatic than changes in company fundamentals. In a complex market environment, many investors display behavioural biases such as:

- Anchoring on irrelevant information
- Herding around common beliefs
- Over-optimism, over-pessimism
- Local representativeness bias, in which people assume a sample of recent or local observations represents all potential outcomes

En masse, such behaviour can cause share prices to overreact to actual or perceived changes in a company's fundamental position, such as when the market extrapolates a disappointing recent quarterly result into a long-term trend.

> Wherever there are humans, there are bound to be biases.

Cognitive biases and mental shortcuts are natural human reactions to complexity and uncertainty, which suggests their presence in markets will persist over time. This provides a durable opportunity for investors who can exploit behavioural mispricing episodes.

THE QUALITY BUBBLE

Behavioural biases may partly explain today's Quality Bubble – and its recent modest correction.

The current episode has disproportionately favoured certain sectors as investors chose to reward expensive defensives and growth stocks, which together are labelled here as "quality" for their perceived superior characteristics. We looked at the sector concentration of the most expensive and cheapest stocks in emerging markets. The results were striking.

More than half of expensive stocks were concentrated in just three sectors: IT, consumer staples, and consumer discretionary. The richly valued stocks are defensive staples firms (safety) and darling tech companies (growth). The cheap stocks demonstrated an even greater concentration, with the vast majority of the universe's cheapest issues in the financials, energy, and materials sectors[5]. Interest rate sensitive and cyclical companies, such as banks and energy producers, are deeply discounted.

[3]Shiller 1981a, West 1988, Mankiw and Shapiro 1985 & 1991 and Carsten K. Nielsen 2007. [4]Taleb "Fooled by Randomness – The Scandal of Prediction". [5]Eastspring Investments analysis based on MSCI Emerging Markets data as at 31 May 2014.

Consumer and healthcare stocks make up a relatively narrow part of the benchmark but contain a large portion of the most expensive stocks. The materials, financials, and energy sectors are much larger and relatively undervalued. Figure 2 below illustrates the sectors' current price-to-book ratios relative to their historical averages.

The Quality Bubble means the companies we own tend to be unloved and under-appreciated by the broader market.

It is important for investors to ask whether this valuation disparity is reflective of underlying company fundamentals or caused by other factors, such as investor overreaction. The answer will reveal whether stocks are cheap for a reason or have been discounted beyond their intrinsic value, thereby providing an attractive value investment opportunity.

RECENCY BIAS MAY BE AT WORK TODAY

Recency bias is a cognitive bias that leads people to extrapolate recent observations.

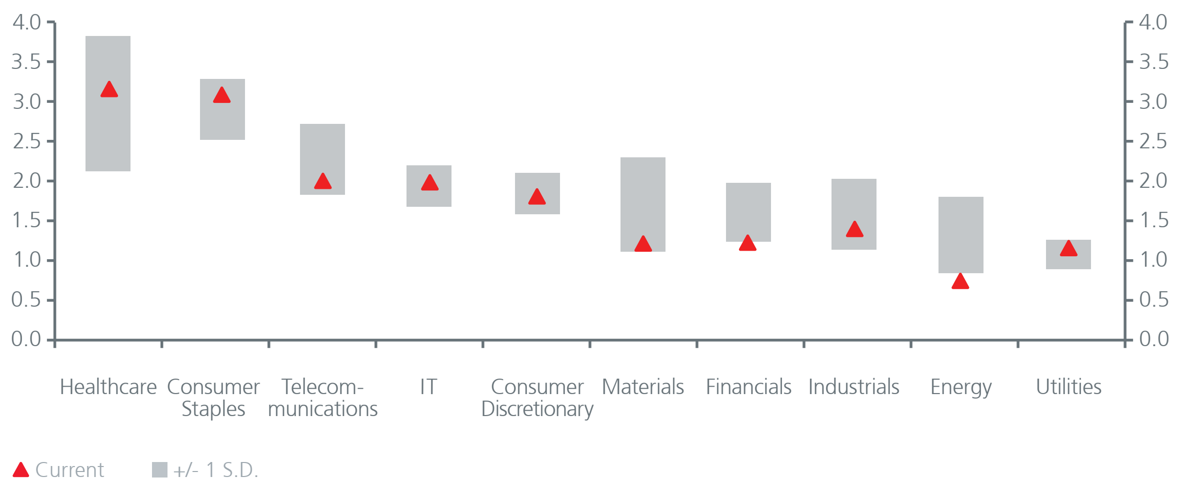
In our view, an extended period of low interest rates following the 2008/9 Global Financial Crisis may be among the factors that have pushed selected stock valuations to extreme levels.

We are hard-wired to place more emphasis on our most recent experiences. Given this, extrapolating the current low interest rates landscape can have a large impact when valuing future cash flows. Utilising a low interest rate when analysing New Economy tech stocks may make large but distant future cash flows look overly attractive.

HERD BEHAVIOUR MAGNIFIES BIASES

A positive feedback loop occurs when investors herd around common observations. This behaviour appeared to be present in the price action of tech stocks, which the broader market continues to reward with some of the highest valuations in emerging markets. Herding can result in inappropriate risk-taking relative to the company fundamentals, irrationally driving prices.

Fig.2. Emerging markets price-to-book (x) ratio by sector



Source: Bank of America Merrill Lynch, as at 30 June 2014. Current 12-month forward Price-to-Book ratio relative to 10 year historical ratio.

WHAT IS OUR INVESTMENT EDGE?

Unlike many core asset managers, we do not claim an investment edge based on superior information gathering or forecasting. We believe our forecast-free approach is a more prudent way to invest because it reduces the risk of unintentional macro bets caused by behavioural errors. We remove personal judgments around macro factors such as interest rates, economic growth, and commodity prices from our investment process and apply consistent, long-term consensus.

Our competitive edge is based on our understanding of behavioural sources of mispricing. When the market is extremely pessimistic about a company, we will focus on understanding its earnings power on a sustainable basis.

> Our ability to look through market noise and "arbitrage time" in pursuit of undervalued companies is an advantage.

We start by looking at what's in the price. Our process seeks an attractive risk-reward in the form of a large discount. We believe the greatest opportunities lie where there is the largest difference between the price and the intrinsic value of a security, which is determined by its sustainable earnings power.

We devote the majority of our time to fundamental research to understand a company's likely level of earnings. Rigorous research and peer review of investment candidates aims to separate value traps from value opportunities and leads to a concentrated, high conviction buy list.

OUR POSITIONING

Currently we find value in stocks in the energy, utilities, and financials sectors. Our highest conviction positions include holdings in Chinese and Indian energy producers; banks and insurers in China, Korea, India and Brazil; and utilities in Korea and Brazil.

We are not structurally anti-quality stocks or anti-tech stocks, but at current levels regard many of them as overvalued. We follow where price and relative valuations lead.

THE OPPORTUNITY

We observe that people have a tendency to overpay for comfort and safety. This may be seen in the current mispricing episode.

Market history is replete with examples of euphoria and pessimism. Although the popular flavour of the day may differ, mispricing episodes and bubbles reoccur because of the presence of hard-wired human biases. History shows that such periods of extreme mispricing are followed by mean reversion.

While we claim no edge in predicting when a reversal will occur, reversal should favour the cheap and out-of-favour stocks we own. In the long run, we believe the market will come to appreciate companies we have identified as undervalued today.

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