Investor Sentiment in Descending Markets - A Look at Behaviour

Richard Harris I Apr 2022

Over the past 2 years, we have tried our best to keep our readers up to date with current market affairs and give an insight into our outlook and thinking. We have based our ideas on prevailing conditions such as business cycles, inflation, increasing interest rates, and psychological tendencies that investors show in different market environments.

All of the above are currently in motion; we have staggering inflation numbers globally, rising interest rates, a notable slowdown in global growth, and both Equity and Bond markets stopping to smell the roses for the first time in 2 years as conditions change and "easy money" is no longer.

The first four months of 2022 have been volatile to say the least as markets have digested the above, together with a variety of policy announcements from both Developed and Emerging market authorities as they try to steer global economies in the right direction without causing too much harm.

For the first time in many years, we have seen a dislocation in the movement of the local (South African) market versus global markets due to demand for our natural resources. The Rand has, therefore, remained strong relative to Developed Market (DM) peers and this has, in turn, affected local portfolios that have been Rand-hedged for obvious reasons.

When markets move aggressively and volatility reigns supreme, it is difficult for many investors to stomach and maintaining a clear mind is sometimes difficult. For April, we would like to discuss a few behavioural tendencies and emotions that investors generally exhibit in market cycles. We would also like to remind our readers that when markets have significant drawdowns, opportunities present themselves in abundance, especially if you have selected managers that have been preparing for such movements.

Behavioural Tendencies in Down Markets

Markets are a strange mechanism when it comes to investor sentiment. Often, investors pile into markets and stocks near the top, expecting already inflated prices to continue (as we saw last year with Technology stocks, etc.). On the other hand, when markets sell off and offer us a "sale" on the same investments of yesteryear, investors shy away and rather focus on the negatives of these opportunities, instead of the fact that such a discount exists.

For good reason, certain asset classes and shares have correctly sold off in the past year. Many displayed "bubble-like" behaviour in the ramp up from March 2020, where many "growth" companies weren't even profitable and those that were, traded on multiples that made very little sense. We must, however, remain cognisant that when broad-based selling does occur, it often causes a ripple effect, and this provides patient managers and investors with opportunities that can significantly enhance client returns over the long term.

This occurs most notably when the stocks that are grouped in with said drawdowns are strong companies with robust balance sheets and a fairly resilient elasticity of demand. It is akin to a fire sale but instead of queues forming around the block, everyone is running for the hills, and for those that have done their research and been patient, it's like Christmas.

Below I will try to highlight a few emotional and cognitive biases that market participants exhibit in times of uncertainty to help us try and better navigate them without letting our emotions get in the way.

Biases exhibited in volatile markets:

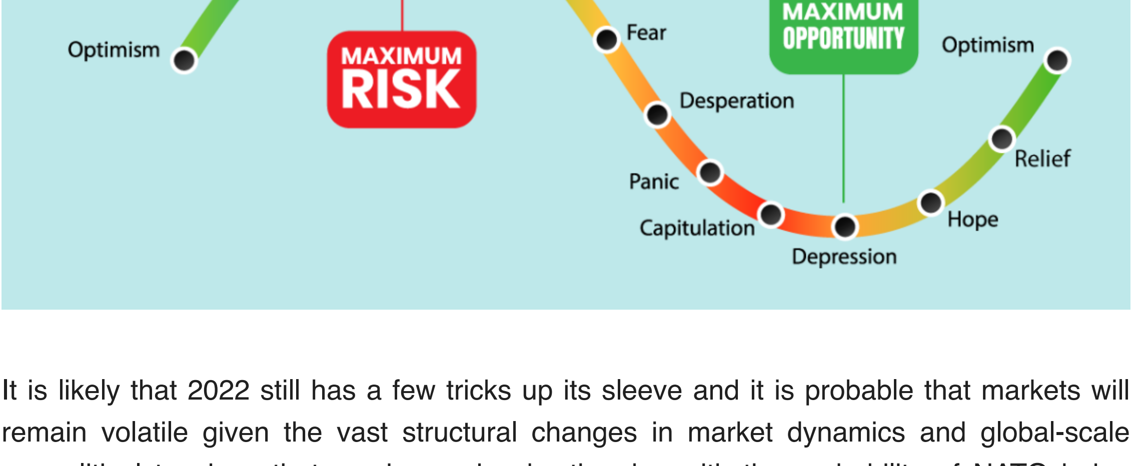
Last year, when markets were exuberant and on their way up, we bore witness to many emotional biases, to mention a few:

- **Overconfidence**: Underestimating risk, highly concentrated portfolios, rejection of contradictory information.

- **Herding**: Investors trading in the same direction, and following the same themes based on feelings of comfort and views of the consensus.
- **Hindsight Bias**: The tendency to see outcomes as expected based on the past and therefore, incorrectly linking outcomes to forecasts.
- **Regret Aversion**: Investors do not want to miss the gains everyone else is enjoying.

One year later, and with markets in a completely different regime, investors are exhibiting signs of uncertainty and fear to some degree. The economic and investing environment now appears somewhat more sullen and we are seeing a reversal in sentiment as a result.

Investors are now displaying signs of fear, anxiety, and denial. Some are starting to panic and would rather sell out of their investments to avoid further losses. As can be seen in the chart below, from past evidence, this is usually the worst time to make such decisions and will inevitably lead to a negative effect on the wealth of those who may have acted emotionally.



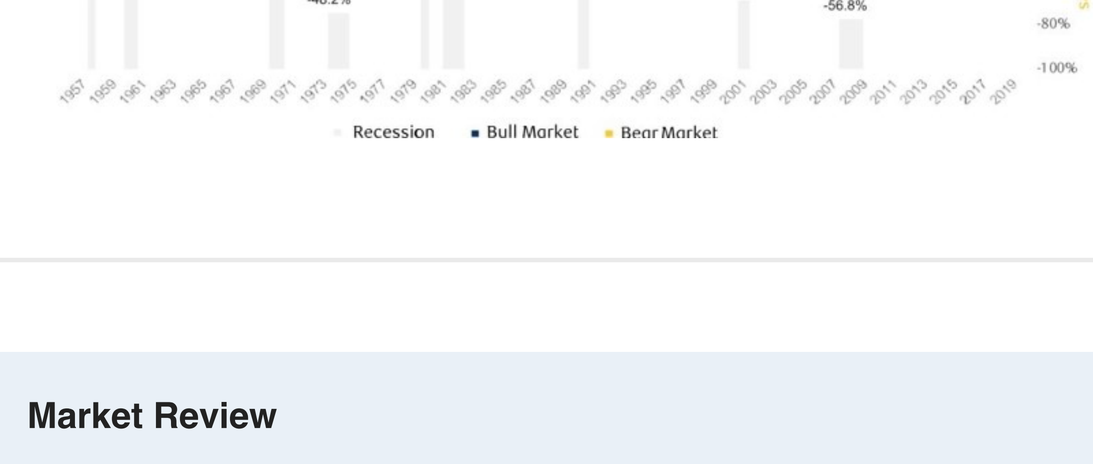
It is likely that 2022 still has a few tricks up its sleeve and it is probable that markets will remain volatile given the vast structural changes in market dynamics and global-scale geopolitical tensions that are increasing by the day with the probability of NATO being drawn into the Ukraine-Russia conflict and potential conflict between China and NATO over Taiwan and The Solomon Islands.

Where does this leave us?

It is hard to tell exactly what point of the market cycle we are in, but it is likely that we are currently in the late part of the economic business cycle. Monetary authorities have signaled contractionary measures to stem inflation, "cool" the economy, and remove excess liquidity from markets that have been exuberant for so many years.

It is likely that markets are going to have continued headwinds over tailwinds in the next year and it is important that instead of panicking, we take advantage of opportunities as they present themselves and ensure that the best options are pursued, keeping in mind that market cycles are natural and if correctly monitored, create exceptional opportunities for clients with a longer-term time horizon.

In times of market adversity, individuals need to remain level-headed and if they have selected the best managers to look after their wealth, trust that these managers will protect their investments. Wealth protection in down markets is as important as return generation in bull markets. Markets don't rise forever and periods of drawdowns like we are seeing now are necessary. If capital is allocated correctly when opportunities present themselves, it provides client portfolios with excellent tailwinds for significant returns into the future.



Market Review

After some market strength into the latter parts of March, April did not fare the same with notable market indexes all in the red. US indexes led the way down with the Nasdaq (Technology) Index falling 11.9% and the S&P500 Index falling 7.9%. Asian indexes also fell substantially as commentary of growth concerns and a weakening economy in China made headlines.

US companies reported their Q1 2022 earnings over the course of April and, with the exception of a few, further confirmed that we are indeed in a slowing growth environment and there is likely more downside to come as contractionary measures have effects on company profitability.

For the first time this year, we saw broad-based selling in commodities as China growth concerns outweighed supply shortages from the Russia-Ukraine war. Investors flocked to the Dollar as global uncertainty remained and risk was taken off the table.

The Rand took a notable knock (-10%) in the last 2 weeks of April, predominantly as a result of the decline in commodity prices and strength of the Dollar, mentioned above. The reliance of our local currency and economy is clearly on commodities and our exports to a large degree and therefore, is something that all local investors should be watching in the coming year.

Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios.

Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

"Risk comes from not knowing what you are doing." - Warren Buffet