

Schroders

Taking Stock

Human behaviour – herd mentality, panic and risk

By Martin Conlon, Head of Australian Equities

I couldn't go past the title of Bjork's 1993 hit in capturing the essence of market conditions at present. Not only do the lyrics capture some of the animal spirits influencing investor behaviour, she was also one of Iceland's few music success stories, an economy providing more lessons than most in the pitfalls of herd mentality, panic and how not to manage risk. Over the last decade or so, Iceland's 300,000 people have had the lot: stock market booms, housing booms and massive economic expansion, culminating in its citizens having the highest GDP per capita in the world. Its risk-taking Viking descendants partied hard, and Iceland's banks managed to accumulate assets equivalent to around 9 times its GDP. As with much of the world currently, the party hasn't ended well and there are some Viking sized hangovers. As Bjork's lyrics point out:

*If you ever get close to a human
and human behaviour
be ready to get confused*

*there's definitely no logic
to human behaviour
but yet so irresistible*

*they're terribly moody
then all of a sudden turn happy
but, oh, to get involved in the exchange
of human emotions is ever so satisfying*

A cursory glance at the newspaper at present finds column after column of analysis on the mistakes made of recent years and the rationale behind them. Most of us are true experts in hindsight. Investors are busy reacting sharply to the wealth decimation which has followed an extended period of easy money and panic is the order of the day. As Bjork noted, investors are terribly moody, then all of a sudden turn happy. March finally saw a few investors turn happy. Most financial market participants describe this moody behaviour as volatility, probably because it sounds more impressive and is conducive to the extraction of a greater fee for its control, a strategy mastered by the pharmaceutical industry, whose participants would never be so daft as to name a drug "Calming Pills" (what self respecting doctor could charge patients a significant fee for prescribing those!). Methasydrohexadodryl would surely command a greater premium.

Humans are, and are likely to remain moody. I have no idea how to predict human behaviour, however, with the knowledge that it is impacting significantly on financial markets at present, and that like Iceland, it may at times move to extremes, I thought it may be worth trying to assess a couple of currently topical issues and the impact which some decidedly moody behaviour may be having on them.

Listed versus unlisted investments

The stoush between the listed and unlisted camps in a range of assets has raged for some time. The intensity has heightened in recent months as listed assets have sharply increased in volatility, causing many to question their appetite for this 'risk'. This seems to me an ideal example of behaviour and emotion prevailing over rationality. The idea that the listing of an asset on an exchange can meaningfully alter its risk profile is one I find perplexing to say the least. There are undoubtedly vested interests in both the listed and unlisted camps, and I'm the first to acknowledge a vested interest in the former camp, however, I'd hope the debate could be based on facts rather than some of the tripe currently being peddled.

Firstly, I think we should clarify one popular misconception. Financial leverage is a totally separate issue to that of an asset being listed. Both listed and unlisted assets can and do use financial leverage. Different levels of leverage will of course mean that the value of equity will move up and down at different rates. The collapse of Real Estate Investment Trusts does not mean that the owners of every commercial property in the country are up the proverbial creek. Whilst the price of a property might fall 20%, that's a slightly bigger issue for owners with 80% debt than those with none. The sooner we get away from confusing the valuation of an asset's ungeared cashflows with the way they're financed, the better. Now back to the behavioural argument I was trying to discuss before I digressed.

Listing an asset creates an efficient mechanism for fractional ownership and a low cost method for allowing buyers and sellers to exchange these ownership shares. If the same group of owners with the same ownership shares, the same assets and the same financial leverage, chose to own through an unlisted vehicle, its price would, in all likelihood, be less volatile, as the manager/valuer of the vehicle would choose to publish a per share valuation which showed little movement on a daily basis. They would have little justification to do otherwise. The listed asset on the other hand, in providing the owners the opportunity to convert their investment to cash in a very short time frame, allows the price to move up and down (perhaps sharply) as owners who are either forced or willing sellers, allow the daily price to be set at the point at which a willing buyer is found. For those not obligated to sell during any particular time period, the cashflow and fundamental value outcome will be the same. The path to this outcome will look very different if you choose to place emphasis on the number and variability of observations along the path. Therein lies the fallacy of market volatility as a measure of risk. The cure does not lie in delisting assets and convincing ourselves we have reduced risk, or moving more of our assets into a framework of less regular pricing.

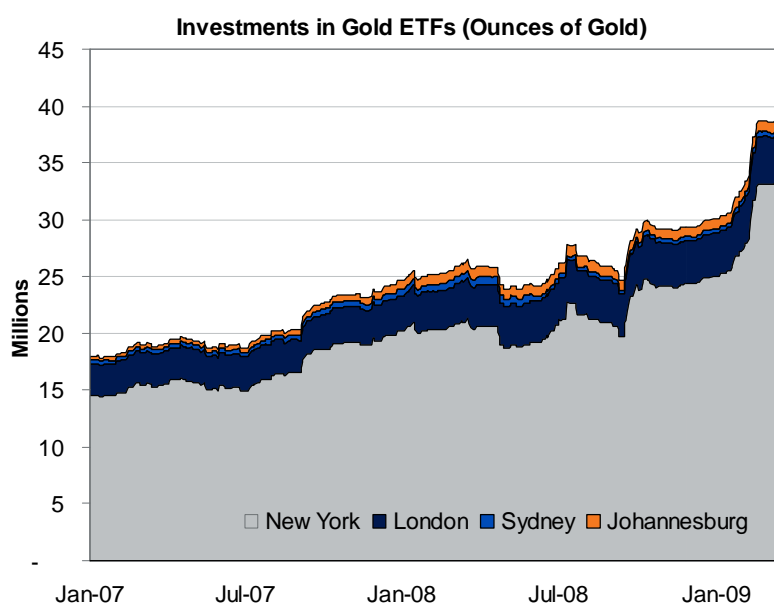
Human behaviour will always be a major factor in setting the price of anything. Whether we are talking about residential property, shopping centres, shares in mining companies or tulip bulbs, emotion and sentiment will be major factors. Stock exchanges just let the process happen constantly rather than irregularly, and avoid having an intermediary deciding the price at which others buy or sell. Think of it as eBay for company shares. Like free trade, I am of the opinion that the provision of a cheap and efficient method for exchanging assets is generally something that should be encouraged. My message to those who envisage an antediluvian world in which we pretend things are better because we can decide when people buy and sell and at what price is this: Wake up, this is the 21st century. Your old mountain bike isn't going to be worth any more if you ban eBay!

Commodities as an inflation hedge

The pervasive concerns of investors tend to ebb and flow between inflation and deflation. Having spent 2008 worrying about the decimation inflicted by the debt crisis and the likelihood of deflation, many now worry that the actions of central banks in easing monetary conditions and increasing money supply, will lead to rampant inflation. As a relatively large number of portfolio managers spend their time trying to predict macroeconomic outcomes, then assiduously analysing history to ascertain which type of companies or assets performed well in the predicted environment, it is unsurprising that

commodities and gold are emerging as favourites. Enough people engaging in fervent analysis of historical performance make it decidedly more likely that such relationships are repeated.

As I have whinged about on previous occasions, the price behaviour of gold is a classic (and frustrating) instance of this behaviour. As an 'asset' without cashflows that costs money to store and offers little utility (unless of course you like the colour, in which case I would suggest a coat of Dulux), gold is perhaps the ultimate 'behavioural' asset. It rises and falls because buyers believe certain conditions are likely to eventuate, not because investors are re-evaluating the cashflows from an asset or changing the value they place on a stream of cashflows. Almost all those suggesting gold as an inflation or deflation hedge will have as their exhibit A, a chart showing the historic performance of gold in times of panic and recession. Much attention will be lavished on the price rises which inevitably coincide with previous financial crises. Less attention is lavished on the fact that a long term investment in gold is only successful in hedging against capital gain. Commodities more generally have been suggested as an asset class in recent years for their mystical powers in protecting against inflation. Again, magically, as more and more people see the wisdom in this advice, and money flows in behind the idea, prices rise in response and the advisers are accorded hero status for their prescience. The graph of money flows into gold ETF's (exchange traded funds) below is ample evidence of this occurrence at present. According to the World Gold Council, jewellery and industrial demand fell materially in 2008, while investment demand rose more than 60%. What a surprise that the price went up! I'd hazard a wild guess that it will continue to rise if investment demand continues and fall when it stops. I suspect those currently invested in gold will keep promoting its merit, as this presents their only prospect for exiting at a higher price.



Source: GSJBW

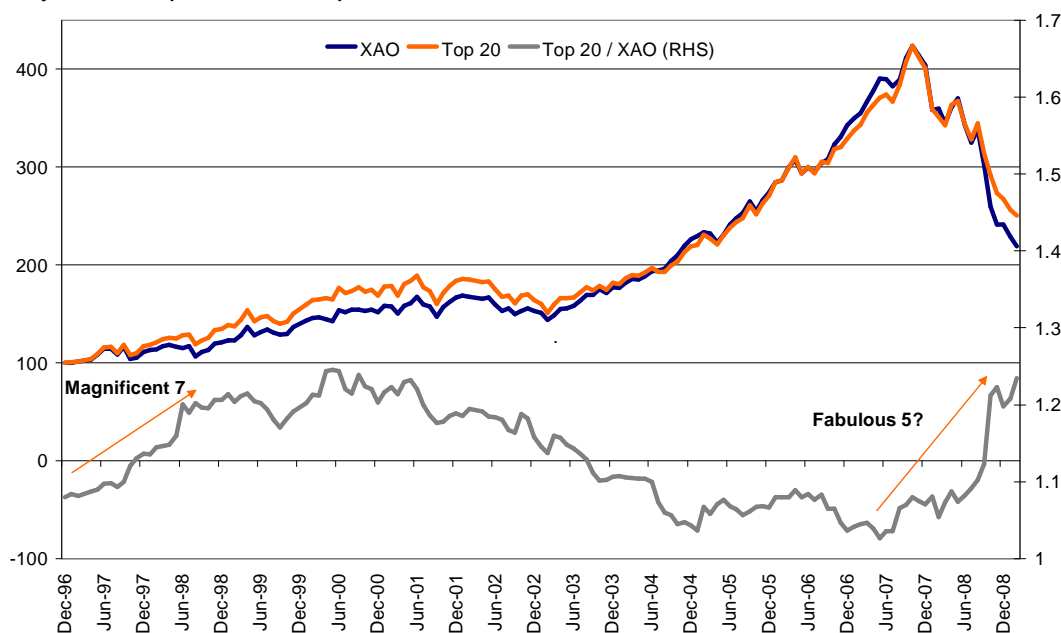
As one who likes to keep investment relatively simple (probably because I don't understand the complicated stuff), it would seem that inflation generally is not a great concern for equities. Inflation causes a decline in the purchasing power of money. This is a concern for those holding cash, but not for those owning the businesses which are raising prices and causing the inflation. Businesses producing commodities may be amongst those raising prices, however, most other businesses will be in a similar situation. Whether it is workers demanding higher wages due to reduced purchasing power, necessitating that wage increases are passed through in goods and services prices or higher fertiliser prices flowing through to higher food prices at Woolworths, inflation flows through the system and is not a major concern for businesses. If this is the scenario investors are worried about, it's cash in the bank and government bonds that are likely to be the problem. In a western world mired in debt problems, I suspect central bankers would be very glad to see some inflation.

Conversely, if it's deflation your worried about, the purchasing power of money will be increasing steadily, and those with cash in the bank will only have the decision on when to spend it. Using your cash to buy gold again seems to be overcomplicating the issue a little. You may as well get paid a couple of percent on the cash in the meantime. In this scenario, those with debt have a big problem and their assets will eventually end up in the hands of those with the cash (at the level at which the holders of this cash eventually choose to part with it). All central banks are trying to do at the moment is encourage people to part with it. As Liza Minelli sang in Cabaret, "Money makes the world go round".

The balance between inflation and deflation determines the extent to which wealth is transferred between those with debt and those without it. There is a valid argument that artificially low interest rates, together with policies which are far too encouraging of debt, have pushed western countries to a point at which painful adjustment is necessary and wealth will be transferred back to those who had lived within their means rather than beyond them. This will always be a controversial balancing act, both within countries and between them, but I don't see much sense in overcomplicating it. Lenders will continue lending when they believe they are fairly compensated for the risk involved, and borrowers will continue borrowing whilst they believe the utility offered justifies the cost of these funds. Like those in Iceland and the Vikings before them, human behaviour will dictate that the scales are almost never in perfect balance.

Market concentration

From January 2008, top 20 relative performance has been extreme.



Source: Macquarie Research

The "Fabulous 5"¹ have taken on the characteristics sought by the market through its decline and the worsening economic environment – large, liquid, perceptions of being financially stable, and not prone to negative earnings revisions. When any of these characteristics are challenged – as occurred with Telstra's downgrade with its H1'09 result in February – the market turns savagely on the stock. This skew has seen the market performance become more concentrated than at any time since the late 1990's, when the "Magnificent 7"² drove the market up. All of these stocks reside within the top 20,

¹ Fabulous 5 include BHP, Telstra, CSL, Woolworths, Origin Energy

² Magnificent 7 include News Corp, Cable and Wireless Optus, Telstra, CBA, BHP, Rio and PBL

and when combined with the relative outperformance of the banks, it has seen the top 20 relatively outperform the market by the greatest margin seen in 10 years through the past five quarters.

Conclusions

As far as our investment process is concerned, our objective is to be as rigorous as possible in ensuring that it is the fundamentals of an investment, rather than prevailing sentiment, which dictate how we invest our client's money. In times when animal spirits run high, and human behaviour is perhaps more emotional than rational, these disciplines are more important than ever. Risk should primarily be dictated by the sustainability and predictability of the cashflows of a business, how much financial leverage is employed against them, and the multiple at which those cashflows are purchased. Whether the price other investors choose to pay for the cashflows changes frequently or irregularly will not feature highly in our assessment of risk, only in the opportunities this presents us with.

In times when pessimism and panic dominate, such as the present, it is unsurprising that the herd gravitates towards the perceived safety of large, liquid stocks with moderate to low financial leverage and away from smaller stocks with a greater degree of leverage. This is patently evident at present and has seen the performance of a small number of leading stocks diverge sharply from their smaller peers.

Popular wisdom dictates that those pursuing this behaviour believe they have reduced risk in taking these steps. In reality, it is likely that they have swapped risk stemming from lower levels of liquidity for a greater degree of valuation risk and probably sacrificed portfolio diversification in the process. They may feel like they've shed risk, however, from our fundamental risk based view of the world, I wouldn't be so sure. For those whose investment philosophy remains based on trying to predict the next change in human behaviour, we wish you luck, but as Bjork says, "be ready to get confused".

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this article. They do not necessarily reflect the opinions of Schroder Investment Management Australia Limited, ABN 22 000 443 274, AFS Licence 226473 ("**Schroders**") or any member of the Schroders Group and are subject to change without notice. In preparing this document, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was otherwise reviewed by us.

Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this article. Except insofar as liability under any statute cannot be excluded, Schroders and its directors, employees, consultants or any company in the Schroders Group do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this article or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this article or any other person.

This document does not contain, and should not be relied on as containing any investment, accounting, legal or tax advice. Past performance is not a reliable indicator of future performance. Unless otherwise stated the source for all graphs and tables contained in this document is Schroders. For security purposes telephone calls may be taped.