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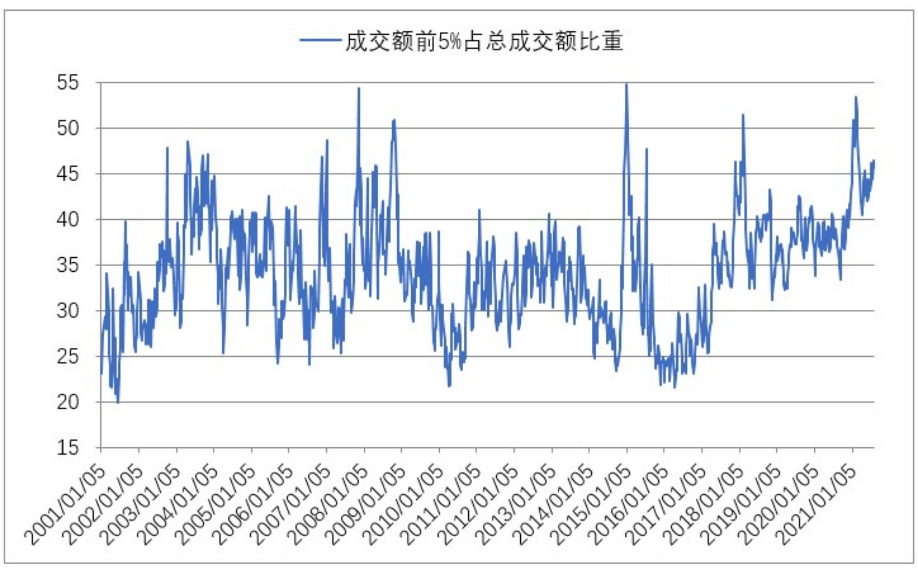
Rosefinch Research | Stay rational in front of crowded trades

Legendary investor Peter Lynch had a famous "cocktail theory." When he goes to a cocktail party, if the guests are more interested in the dentist than him, then the market is usually weak; if guests are willing to chat about stocks but still pay attention to the dentist, then the market is ready for a rebound; if guests AND the dentist are surrounding him and ask for stock tips, then the market is near the highs; and when people start to recommend stocks to him, then the market is at the peak. It's an interesting description of market psyche and we see similar situations in the latest A-share rally. One Chinese report says one big client was so unhappy with a fund performance that he told the Fund Manager that unless the fund buys more New Energy stocks, he will redeem his investment from the fund. The investor could hardly hold himself back from rushing into the market and jump on the crowed but profitable trades. One wonders about this scenario of retail investor teaching the Fund Manager… seriously?

University of California professor Barber and Berkeley professor Odean did a behavior analysis on investors. They concluded that since retail investors usually have little insights about the thousands of stocks, they'd normally choose whatever is the recent hot stock. The institutional investors did not share the same behavior in the study. The researchers thought it was due to the relative mature investment process of the institutional investors.

Recently, the A-share have shown heavy concentration amongst the high-volume stocks. The total percentage of high-volume stocks are picking up, with the hot industries getting even more crowded. According to Wind, during the week of Aug 2nd to 8th, the stocks that have top 5% in individual volume account for 45% of total volume, which is near the highs since 2001.



Source: Wind, Rosefinch. % of total volume by stocks with top 5% individual volume.

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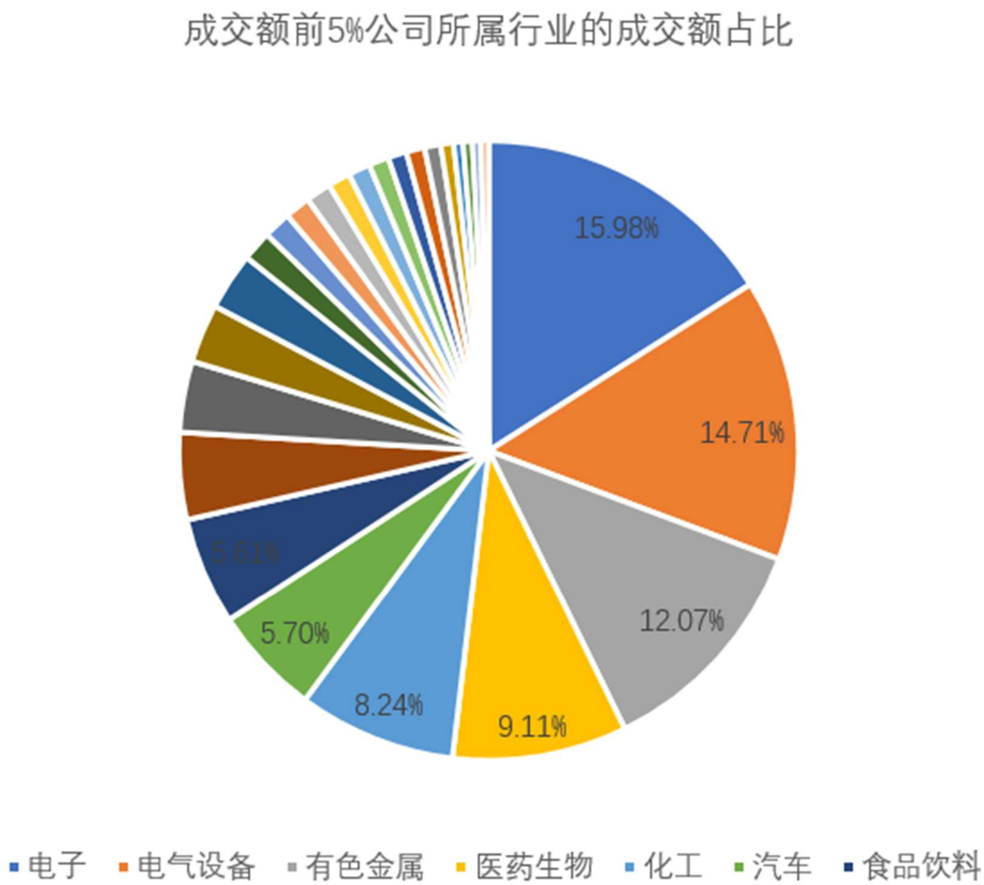
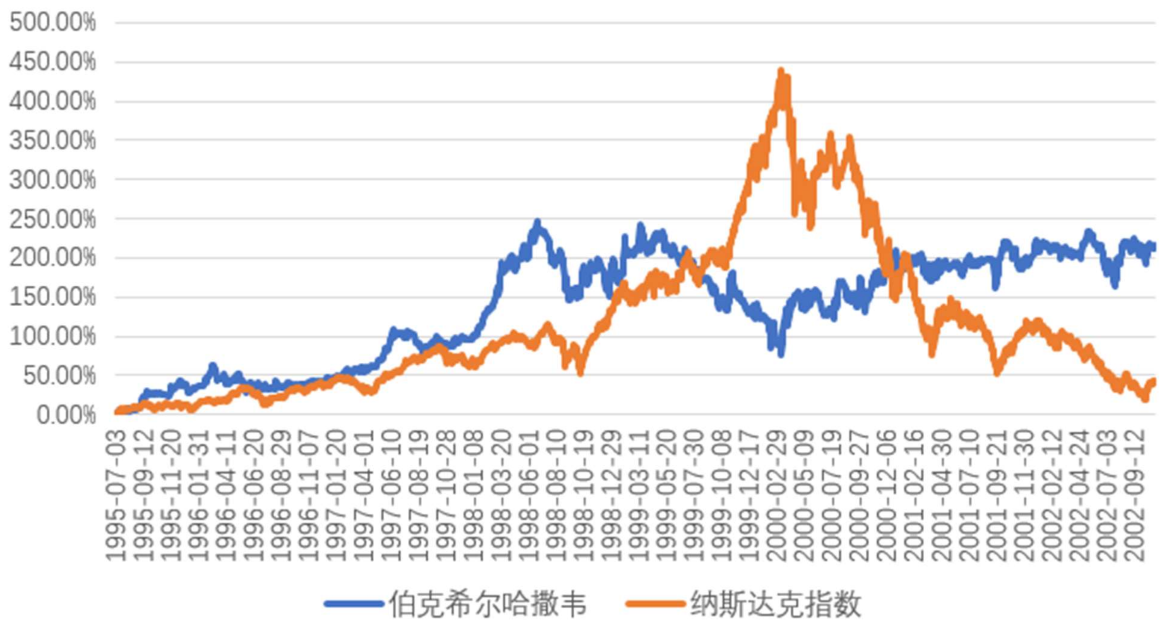
Not surprisingly, the stocks with top 5% in individual volume come from a few hot industries: electronics, electric equipment, non-ferrous metal, biopharmaceutical. These four industries account for 50% of total volume. The flush of capital raised the stock valuation multiples quickly and reduced their value-to-price ratio. This linear push of "higher price begets bigger enthusiasm" is clearly not a rational framework.



Source: Wind, Rosefinch. Leading industries are electronics, electric equipment, non-ferrous metal, biopharmaceutical, chemical, automobile, food and beverage.

In Taiwan, there was another interesting study by Taiwan University's Chuang and Houston University's Susmel. They analyzed the trading behavior of a group of Taiwan retail and institutional investors. The result showed that both retail and institutional investors will be more aggressive during market upswings. But once the market consolidated, in the subsequent phase, the retail investors are clearly more aggressive with risky stocks than institutional investors, or more likely to trade during period of high market volatility, or trade more actively. When retail investors are rushing into the market near the highs, the disciplined fund managers with clear value-investing framework will become contrarian investors. The mature investors have lived through their battles against the market. The active investment's core mandate is to outperform the market. This means investors must find the divergent opportunities in the market and discover the incorrect pricing. But market is full of uncertainty, and no one can predict exactly when we'll return to the average valuation. Equity market can stay in over-value or under-value status for extended periods of time. Even Warren Buffett had an extended period of time where he underperformed the market. From 1995 to 2002, NASDAQ outperformed Berkshire Hathaway by almost 300% at one point.

When the house of cards cannot be supported by profits, it will eventually collapse. In March 2000, NASDAQ scaled over 5,000, and then reverted to long-term valuations. Over the entire period from July 1995 to Oct 2002, NASDAQ rose 42%, while Berkshire Hathaway rose 216%, and with lower volatility and much smaller drawdown than NASDAQ.



Source: Wind, Rosefinch. Blue is Berkshire Hathaway; Orange is NASDAQ.

The competition amongst nations ultimately is the competition amongst core technology. For medium to long term, the emerging strategic industries will be the next round of industrial investments. But profit and valuation will remain the keys to investment strategy. If valuation is too high and avoid investment, we may lose the investment opportunity; but at both industry and company levels, if the growth logic is challenged or proven to be false, there will be the double whammy from downgrades in both performance and valuation multiple. As we base our investment decisions on industry development and long-term company's competitiveness, it's important to add deep understanding of the entrepreneur.

As an investor, when your friends are making hand over fist on hot stocks, can you stand your ground? Once you give in and join the chase, it's easy to buy high and sell low. We did an A-share analysis in our recent paper "Winner's Curse". We compared the ten-year results in A-shares from A) always buy the top performing mutual funds from the previous year; and B) always buy the bottom performing mutual funds from the previous year. How much would the 10-year total return differ? It turned out both strategy A and strategy B had returned about +100% in that 10-year period, whereas the average mutual

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fund performance was over +200% in that same period. Chasing the wind seems to give sub-optimal returns.

Rather than chasing the hot ideas in the high-valuation industries, it may be worthwhile to spend the limited time and energy to uncover high-potential ideas that market missed.