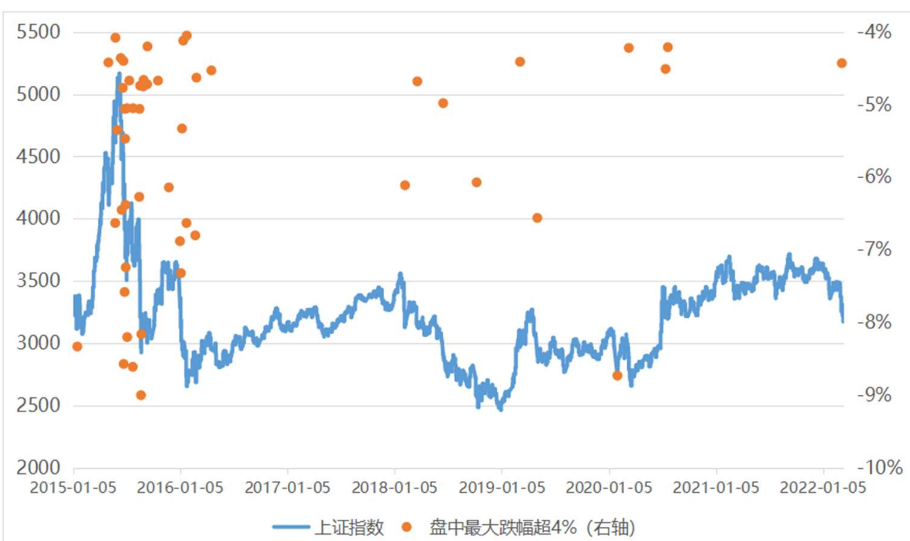
Rosefinch Research | 2022 Series # 9

Thinking of Animal Spirits

In the past week, Russo-Ukraine conflict worsened, another pandemic wave returned to Hong Kong and now China, liquidity worries abound, and even as we write today, the Shanghai stock index is down -5%. We don't experience such drops often: Shanghai stock index had daily drop of over -4% in only 51 of the last 2000 trading days since 2015. In fact, most of them occurred in major correction phases in A-shares from 2H15 to early 2016, and during 2018. There were also a couple of such days in 2020 when the Covid pandemic first broke.



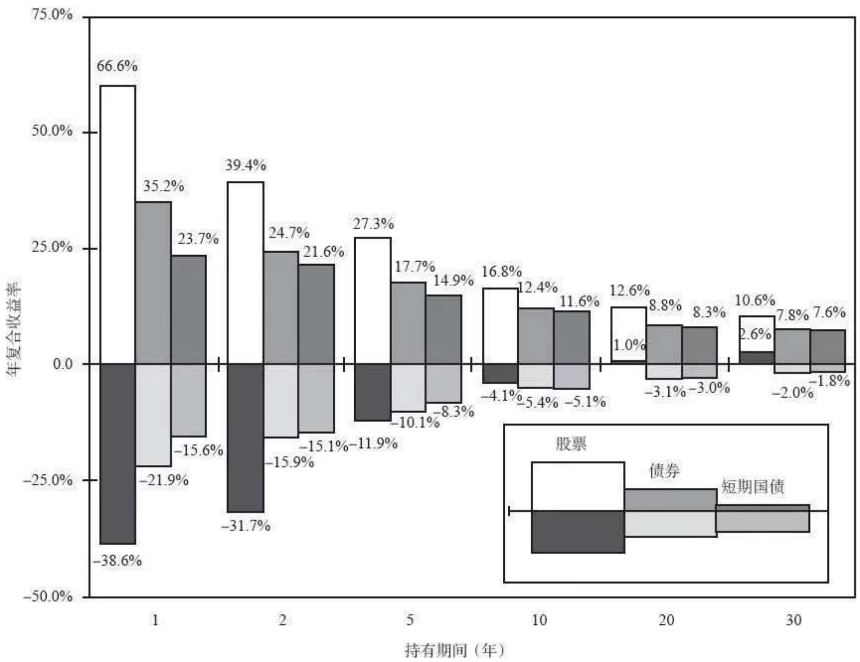
Source: Wind, Rosefinch.

Some market commentator remarked that this round of correction was notable for its negative feedback loop. The bearish sentiments caused selling which led to lower levels that in turn generated more stop losses and negative sentiments. There were some market products that had stop-loss limits which forced the managers to liquidate as NAV approach these levels, further accelerating the pace of selling. The panicked selling has no fundamental explanations, just like the "irrational exuberance" is disassociated from fundamentals. When the rally exceeded what's supported by the underlying business, the excess return will come from increase in valuation. Some increases may be based on solid fundamentals with strong sustainability, while others may simply be a mirage that can come and go in a flash.

The battle between the buyers and sellers determines the short-term market direction. When the two sides square off evenly, the market pushes and shoves until one side takes the lead to establish the trend. The trend then builds further, sometimes even accelerates into the over-bought or over-sold area. As we move into the market extremes, the "animal spirit" is dominating most participants' minds. Keynes observed that people must depend on confidence when they make major investment decisions. Most of our decisions, such as how much or what to buy, are made because they "looks right" at the time. Sometimes, the confidence is well-placed, while other times is less so. The investors most known for their conservative style at their time was Dutch who pioneered the insurance industry. Ironically, they were also the one who brought us the first financial bubble via the tulips.

Robert Schiller, author of "Animal Spirits", wrote that since the founding of United States, the economic recessions have been seen as a result of lack of confidence. Therefore when the US stock market collapsed in 1902, JP Morgan and other major financiers moved to invest in the stock market, trying to rebuild confidence. US President Franklin Roosevelt also said in his inaugural address during the 1933 Great Recession: "the only thing we have to fear is fear itself." **As we struggle in the waves of emotions, the fundamentals become a true and trusted anchor.** Relative to the emotional roller coasters, the fundamentals are much more dependable: you can see the order log, touch the finished product, analyze the competitive landscape, assess the entrepreneur spirits… In the long term, "volatility" is not a bother, but "permanent realized loss" is the real danger.

If we compare the risk characteristics of stock, bond, and cash and rank them, most of us would put stocks as the riskiest asset. But what if we consider different time horizons – will their risk profile change? This was the question studied by Jeremy Siegel in his book "Stocks for the Long Run." He analyzed the annualized returns of US stock, bond, and short-term bills over 1- to 30-year periods since 1802. Specifically, Siegel compared the range of inflation-adjusted returns of these 3 assets:



Source: Jeremy Siegel, "Stocks for the Long Run"

The data showed that the shorter the holding period, the wider the stock-return range. This is consistent with our common impression of stocks being a volatile asset. Interestingly, as holding period extends, the stocks' range of returns tighten much more quickly than the other assets. **At the same time, if your holding period is at 10 or more years, the minimum annualized return in stocks can exceed that of the bond or bills. Therefore, when it comes to stock investments, time is the enemy of short-term opportunistic traders, but the friend of long-term investors.**

Given that time is the key determinant in equity investment success, then we must be honest with ourselves BEFORE we make the investment decision. Can we hold onto the portfolio for the long-term? Can we withstand drawdowns of more than -20%? Each market drop becomes a stress test, and if it's seriously impacting your quality of life and soundness of mind, you should reconsider your asset allocation ratios.

Warren Buffett said he like hamburgers so that whenever they're on sales, he'd eat more. But some investors throw away the hamburgers when they're on sale, because they suspect the burger has gone bad. We're experiencing a classic over-sold situation that's released a lot of negative sentiments already. Some excellent companies are offering shares at great values. Whether or not we have bullets left, it's time to become more optimistic about the future. **After all, no Winter lasts forever and Spring is just around the corner.**

In China, one of the most respected doctors in the Covid pandemic is Doctor Zhang Wenhong. He's most well-known for being a straight-shooter and an honest & credible expert. China has been battling

[021]2030 5888 [021]2030 5999
58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
上海市浦东新区海阳西路 555 号/东育路 588 号前滩中心第 58 层，邮编：200126

Covid for two years under the "dynamic zero" policy where entire buildings, neighborhoods, cities, and now province can be locked down for days and weeks. Recently, Dr Zhang shared his view on the future responses to the evolving pandemic: "when we see the road ahead and we know the Spring is coming, what's there to be afraid of?" Just like to err is to be human, it's natural for the equity market to fall from time to time. **As long-term investor, we know that this correction will just be another footnote as we grow with fundamentally excellent companies well into the future.**