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To Be a Cautious Optimist

In the last ten years, it's never been this hard to be a Chinese equity investor. We're almost 2/3 of the way through 2023, and most of the "top ten predications" of major equity houses have missed by a wide mark. After the July 24th government conference, many optimists rejoiced with bold predictions of "market bottom" is near or has passed, only to see the market going one step forward and two steps back, retreating now to the low of the year.

The current correction cycle has its origin in the start of 2021. Chinese equity peaked in Feb 2021, and has had retracement of 39% since. After nearly two years of adjustments, we're still about 30% off the 2021 peak. In the previous two rounds of bear markets, while the drop was drastic, the rebound was fast. In 2018, CSI300 retraced 32% first, and then recovered within a year; in 2015, it dropped by half, but had the slow bull market within 6 months. But this round of very slow recovery can be traumatizing for investors who have not experienced it before. The closes historical episode similar to current environment is probably the A-share market back in 2009-2012.

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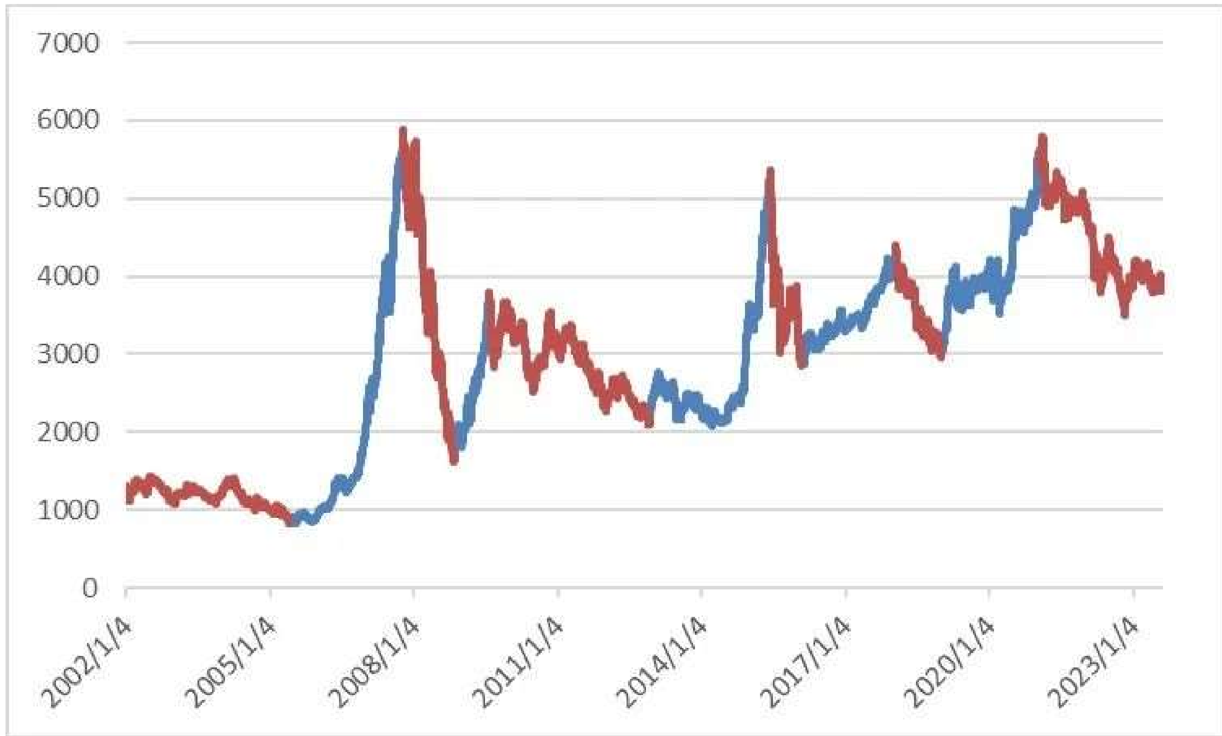


Source: Wind, Rosefinch. Historical data is not future predictor, and does not constitute investment advice.

At the same time, active management strategies are running into head winds. YTD equity-biased fund index lags CSI300 by over 5%. The last time active managers underperform CSI300 by this much was back in 2017. Market sentiment has been time and again as these rare occurrences compound on each other.

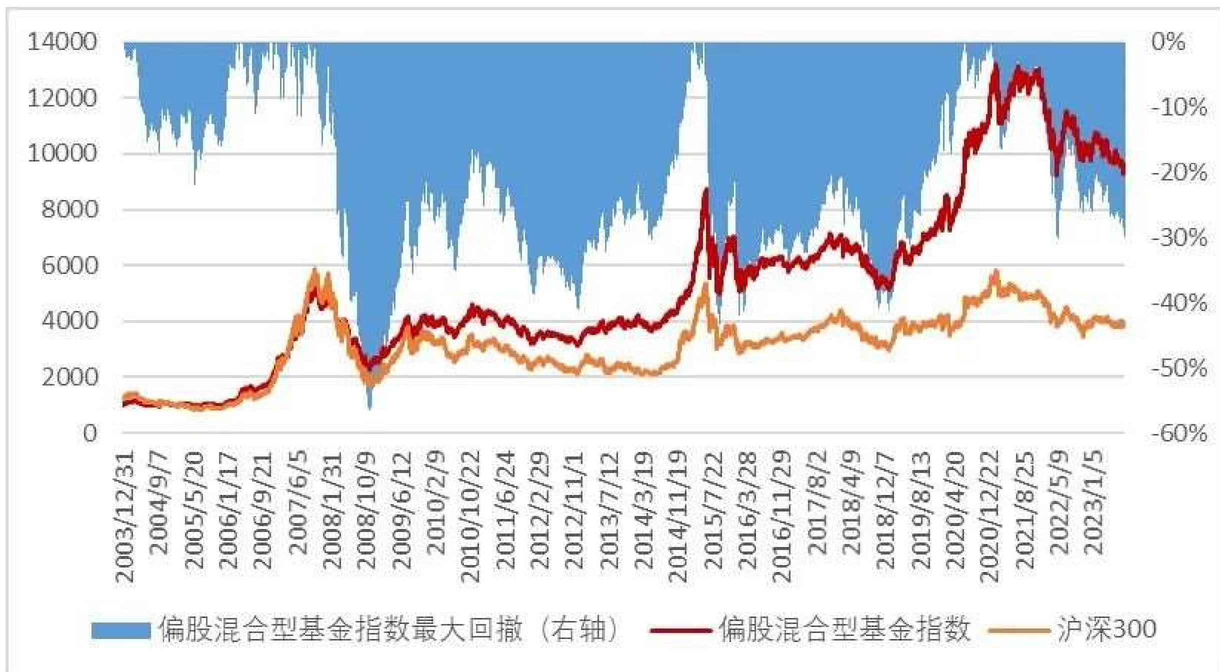
When facing a dilemma, time is a potential solution. Graham said: “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” A company’s short-term pricing may be impacted by sentiments and emotions, but its long-term value is dependent on the company’s present value of future profits. Graham didn’t clarify the specific time frame for “long run”, so we have to face the uncertainties of the market when it persistently mis-price valuable companies.

If we take a look at US stocks in the 1970s, we may notice similar backdrops: geopolitical conflicts stubborn inflation, crash of Nifty-50 stocks, and sideways S&P over ten years. In 1978, BusinessWeek published an article titled “Death of Equities”, effectively capturing the sentiment of the times. With a bull market no where in sight, it wasn’t hard to imagine who investors may write off equity completely after years of painful disappointments.

Turning points are impossible to pinpoint, but when the spring is overly compressed, there will come a point when the limit is reached and the market reverts to its more natural state, recognizing valuation along the way. In the 21 years since the “Death of Equities” article, the internet went from birth to explosive growth, with S&P reaching annualized return of 18%, doubling its normal long-term annual growth.

So if Graham is right about the long run property of "weighting machine", how will it be applied to fund investment? How long is a "long run" for fund investor? Aside from the time cost, a fund investor must also factor in the challenge of drawdown. A few years ago, active managers were beating the market handily. Fund investors come to expect that the longer the holding period, the higher the profits. The market turned quickly, however, and the fund returns reality has lagged significantly from expectations. In the last three years, over 70% of the active equity fund managers reported negative returns, with an average return of -9.5%. (Wind data).

If fund investment reduced the risk of retail investors' frequent trading and buy-high-sell-low behaviors, it does introduce a new risk: timing of entry. If the investor buys funds at the peak, it may take longer to capture value over time. Since CSI300 was launched, it had reached above 5000 three times: 2007, 2015, and 2020. While active stock funds set new highs throughout this period, the index though still has not returned to its 2007 peak. As a fund investor, if you bot at the time of previous highs in CSI300, it'll take you 7 and 5 years respectively to make new highs. But investors rarely think of the risk of being the unfortunate souls that bought this high. It may be worth preparing psychologically by asking ourselves: what if I bot the high on this cycle? How does that affect my investment plans?



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Murphy's Law tells us things often take a turn for the worse. Those low-probability events seem to happen with alarmingly regular frequency. Geopolitical conflict, de-globalization, disjoint monetary policy cycles, aggressive FED hikes, all these unpredictable events became mist that limit our investment vision.

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Investment is the art of risk management. Even if we can't see clearly very far, we still can think about what to do we the Black Swan arrives. Just like driving in pitch Pdarkness: the goal is not to be the first to reach the finish line, but to learn to control our speed so that the breaking distance is within the area under the headlight.

William Miller was the legendary CIO of Legg Mason Capital Management who beat S&P for 15 years in a row from 1991 to 2005. His investment strategy to buy under-valued stocks in high concentration suffered during the financial crisis. By the end of 2008, his funds ranked as bottom 1% in annualized 3y, 5y, and 10y returns.

Taleb once said: "I'd Rather Be Dumb and Antifragile Than Extremely Smart and Fragile." And in the world of investing, there's never been a lack of smart people. Often times, those who survive the market are often those who are more conservative and stay cautiously in their field of competency.

Being cautious and being optimistic, these are two opposite qualities, yet both are required for a successful investment career. An excellent investor will believe economic growth will continue and capital assets will increase in value over time. On the other hand, the investor will also base the optimism on rationality, and seek out mis-pricings in a market that is full of fear and greed.

This is not the first time for a sizable market correction, and we believe it won't be the last one. When the eggs are in a secure and safe basket, it's worth being flexible with risk exposure, be a cautious optimist, and wait for the winning moment.

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