The Issues

September 3, 2010

BEHAVIORAL FINANCE: ANCHORING

"Anchoring" is innate to human behavior—the brain uses references, or anchors, to respond and react. Crowd or herd psychology is a good example. Imagine watching your favorite soccer team on your digital home theatre versus being right there in the stadium. Rationally, you can witness the finest goals scored on your HDTV, with instant replay, in the comfort of air-conditioning and on a soft sofa at home. Additionally if you're watching in person from the stadium, actions on the field are so fast that you're almost sure to miss some of the details of those defining moments that make these players world-class athletes. Logically, therefore, you would prefer to watch the game at home. But the human brain is driven more by emotion than logic: The feeling at home is just not the same as being there because, in person, the roar of the crowd is a self-reinforcing, psychological anchor that lifts your excitement sky high.

In the sections below, we discuss how the brain, working with *different types of anchors,* affects the way we invest:

1. Herd Psychology. The roar of the crowd at a soccer game is a powerful anchor. In a powerful stock market rally, bullish psychology self-feeds, driving analysts who are smart and normally logical, to revise their share price targets successively upwards into irrational bubble-type overvaluations. In a market plunge, the reverse happens. The history of market booms and busts has repeated itself so many times, psychology clearly dominates logic in stock markets.

2. Investment Themes. Faced with a wide variety of securities, sectors and markets, how would the average investor know what to buy? Investment themes, based on clear, identifiable ideas and easily understood parameters, are significant investment anchors that attract the psyche of a majority of average investors. This is why key themes are always behind all bull markets, driving shares and sectors that provide market leadership. Conversely, market corrections/consolidations are led by the breaking down of the leading themes with no replacements.

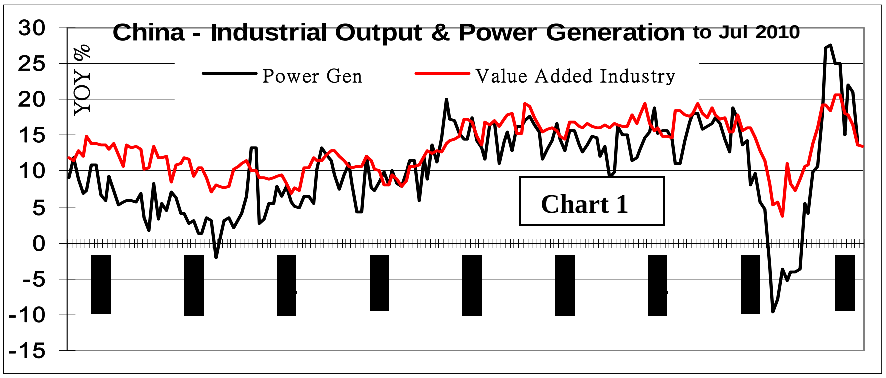
While on the subject of investment themes, exchange-traded fund (ETFs) are anchor products created by investment bankers that offer theme-based investments in gold, commodities and emerging markets. ETFs have so quickly grown to be so hugely popular that the degree of fund flows in or out of them now offers a good contrarian indicator about whether an investment theme is over-owned or over-sold.

3. Anchors as Guides. During times of uncertainty, the human brain looks for direction from anchors. Investors look at the direction of Wall Street for pointers on the course of the U.S. economy, for example. This explains why markets don't decouple when times remain uncertain. However, the Dow Jones is a price-weighted index of 30 large U.S. corporations, and the S&P 500 represents 500 U.S. large-cap stocks. It is illogical that the share prices of a few hundred large firms in the U.S. would reflect the broader economic and business fundamentals of the eurozone or the Asia region. But market psychology-wise, the influence is there—Wall Street goes up, most others follow, and vice versa. And the bigger the participation of global funds, the greater the correlation of markets as fund managers follow one another, like a herd.

4. Stock Values. We use historical PER or PBV (price to book value) bands to determine stock values. In the strictest sense, these are anchors. What is the economic rationale of comparing the share price to earnings-per-share (of *one* particular year), i.e., the time (in years) it takes for a company's earnings in the chosen year to multiply to equate the current share price? None. Earnings change year to year and, theoretically, the return to a shareholder comes not from earnings per share but from the dividend stream. In financial terms, the PER ratio is thus meaningless. Widely used nevertheless, the ratio offers an anchor, a reference point. And as reference points go, the judgment is subjective: The same share can be cheap on a PER of 15 in a bull market and expensive at a PER of 10 during a bear run. It is thus *important to study market psychology because valuation anchors show at best only half the picture.*

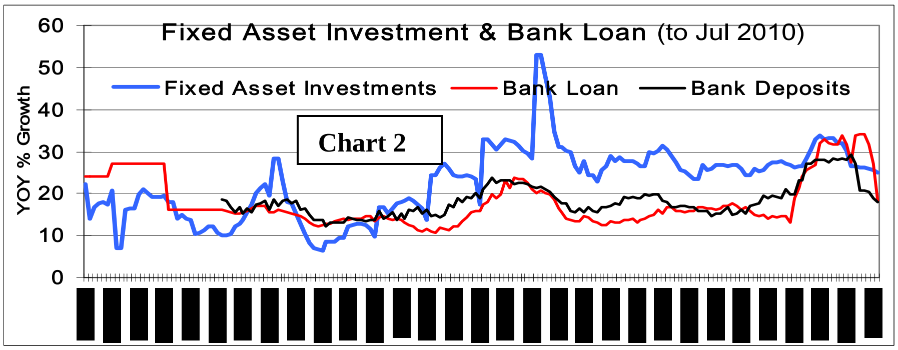
Some contrarian-type analysts have been arguing that time is near to reinvest in China-related shares, given the long period of correction, and that valuations are now "cheap." How can we apply the concept of anchoring to decipher the outlook of stock markets in China?

China—Investment Themes Are the Drivers, not PERs, GDP or Earnings



Are GDP growth, the export and investment cycles, earnings and valuations the main driving anchors of stock market direction in China? Evidence over time suggests that is not the case.

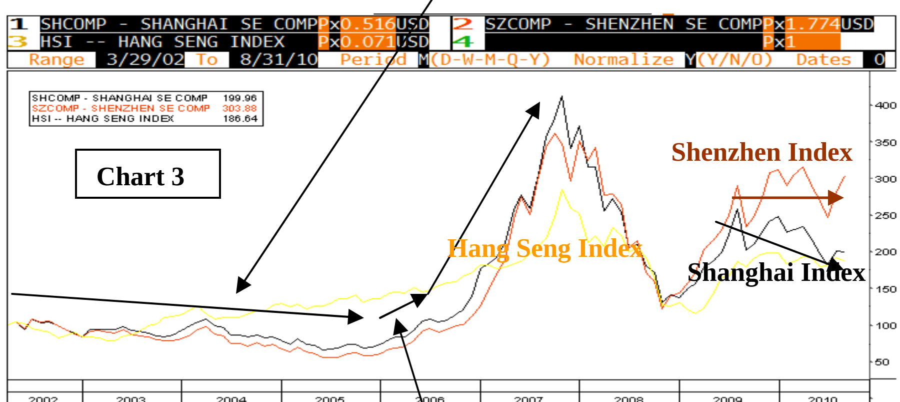
From the beginning of 2002 to mid-2006, China's economic numbers, exports and fixed investments were accelerating (Chart 1 shows the rising trend of industrial production as proxy). And Chart 2 shows the sharp acceleration in fixed investments in 2002 to 2003, coupled with a rise in liquidity (bank loan injections) in the economy.



Logically, easy liquidity conditions plus rising economic activities mean a bullish backdrop for equities. Instead, the stock market remained decidedly bearish from 2002 to 2005 (Chart 3).

Sources: Charts 1–2: CEIC, Wind Data; Chart 3: Bloomberg.

Individuals are the main participants in China's A-share market. *The dominant anchor of their investment behavior is investment themes, not economics and finance. And the driver of themes in China is government policies.*



For several years prior to 2006, the central government talked about A-share reform (conversion of non-tradable shares to tradable) but with no concrete plans. Non-tradable shares constituted nearly 70% of issued capital, an overhang issue that caused the investment public to shy away from equities.

Starting in 2005, certain companies experimented with A-share reform by giving bonus shares as compensation to holders of tradable shares. This was done to entice them to vote in favor of A-share reform on the condition that release of non-tradable shares to tradable would be spread over several years. On the back of the success of these early experiments, the authorities allowed all listed firms to pursue share reform using a similar approach. The removal of uncertainty related to the overhang of non-tradable shares then lured the public back to equities. A gradual rally commenced by 2Q06 (Chart 3).

Anchor Investment Theme

Concurrently in 2006, the central government embarked on an active program to promote the mutual fund industry. This policy was interpreted by the general public as an implicit Beijing endorsement that the stock market offered a good investment outlet, a useful alternative to keeping savings in banks, and that the government desired a vibrant stock market to help facilitate the A-share reform. Momentum built on that theme, and the Shanghai Index soared 4x, to 6,000, by October 2007, propelled by a huge inflow of public savings into mutual funds. The bull run from mid-2006 to 2007 was not led by economics such as a surge in money supply, loans or an upturn in the investment cycle (Chart 1).

By mid-2007, the central government was increasingly concerned about the risks of a market bubble, given the sharp gains, signs of widespread investor greed and the consensus bet of a government "put," meaning Beijing would adopt policies to keep the market buoyant. Authorities finally took steps to release mega-size IPOs and equity issues to curb the exuberant market psychology, and investors ultimately recognized that the government had reversed its policy stance. The driving theme broke down, and the Shanghai Index plunged from 6,000 in October 2007 to under 1,800 by October 2008.

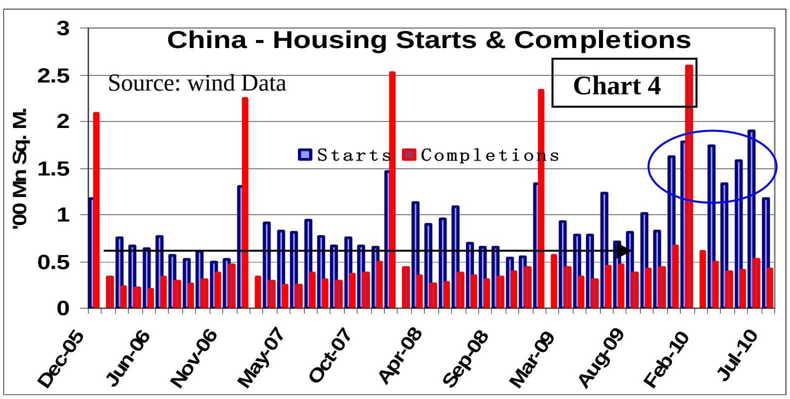
Current Situation

The index staged a rebound to 3,500 by mid-2009. Coming after such a huge plunge and on the back of the biggest-ever explosion in bank credit and liquidity in 1H09, this market rebound had modest power. Since then, it has retreated to ~2,600. YTD, the Index is down 25%. Sentiment is held back by Beijing's policies to restrain credit and clamp down on the property sector (a major segment of fixed investments). Major banks have been forced to issue shares to raise capital.

Large-cap stocks in financials and materials (petroleum, steel, etc.) compose over a 60% weighting of the Shanghai Stock Exchange Index. These sectors are themeless; hence, the bearish trend of the Shanghai Index. Domestic mutual funds and veteran individual investors have avoided these large caps, participating instead in individual stocks and sectors—witness the outperformance of the small- to mid-cap dominated Shenzhen Composite Index (Chart 3). Bank deposits, although down from +30% YOY at end 2009, are still up +20% YOY, so plentiful liquidity exists. China's bourse has been *a market of individual stocks and sectors and, for the reasons discussed below, this backdrop is likely to remain into 2011.*

Beijing versus Local Government Officials in the Run-Up to 2012

The governing dynamics of central policies in China now are the politics of the once-every-five-year changeover of government officials, due next in early 2013. Officials in local governments (and their vested interest groups), while they hold office until 2H12, are keen to invest in projects and spend money. This underlying behavior drove the explosive loan growth in 1H09 and is why the central government lost control when they opened the credit gates in 1H09. Will Beijing run the risk of losing control again and thereby introduce further economic volatility ahead of 2012? We think it's very unlikely. Policy changes from now and into 2011 will likely be very gradual and targeted at specific areas. During this adjustment period, China's stock market will likely remain sector and stock specific, as will our investment policy.



Housing

This sector is a socially and politically sensitive area in the run-up to 2012. In tier-one cities such as Beijing , Shanghai, Shenzhen and Guangzhou, the ratio of housing prices to household incomes are at multiples in the high teens.

The lack of growth in completions in 2006-09, despite housing prices up over 2x (Chart 4), indicates land hoarding by developers. Presale payment terms greatly favored the cash flow of developers, allowing them to build land banks.

Developers can often obtain 100% of sale proceeds on presales even though two-thirds or more of the total construction costs remain to be spent in project completion over the next 12 to 18 months. Home buyers thus finance the construction cost as mortgages are drawn when purchase contracts are signed.

The central government's policy is now targeted at squeezing the cash flow of developers to force them to develop idle land banks. This is done by 1) restricting bank credit, and 2) tightening presale rules. The only source of cash flow for developers is to sell land, i.e., start more projects for presale. This has driven a surge in housing starts, more than doubling the rate of the last few years (Chart 4): The surge in supply of housing for sale over coming months will depress housing prices. Should the cash flow squeeze continue into early 2011, we can expect highly geared, smaller developers to fail, marking the end of this downturn, at which point the sector will be interesting again—one example of sector opportunities we see emerging in China.

The Net Asset Values GSI Asian Capital Growth – US$25.38 & The Long Short Fund – US$23.29 (Sep 2, 2010)