What could possibly trouble a tiger?

“Learn every day, but especially from the experiences of others. It’s cheaper!”

- John C Bogle

In 1980, Julian Hart Robertson Jr. launched one of the earliest hedge funds – ‘The Tiger Management’, with USD 8mn raised from friends and family. Based on his brilliant stock picking prowess, the fund enjoyed success very early. By the early 1990s, he came to be known as the ‘Wizard of Wall Street’ and his fund became the largest hedge in the world managing USD 22bn in assets by 1998. Tiger management had a value tilt and the fund used to run long and short positions. In 1999, Robertson had turned bearish on Tech stocks and refused to buy into the internet bubble. He was quite vocal about the overvaluation in this segment in his communication to investors as well as the media. The fund had built short positions in internet stocks by the first quarter of 1999.

The stock prices continued to rally as new investors were flooding into the internet stocks. Tiger fund was faced with deteriorating performance and investor redemptions. In October 1999, the fund increased the redemption period from 3 months to 6 months. Amidst mounting losses, Robertson finally announced the fund’s liquidation in March 2000. He wrote to his investors, “As you have heard me say on many occasions, the key to Tiger’s success over the years has been a steady commitment to buying the best stocks and shorting the worst. In a rational environment, this strategy functions well. But in an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum, such logic, as we have learned, does not count for much.”
The Crash that Robertson was betting on began within a month of the closure of Tiger Management. Isn’t it ironic?

I use this example to tell people about the importance of learning about behavioral finance. The mistakes made by the crowd (market) in their investments can not only create opportunities for one to profit, but also create risks! It is important to know what the crowd is thinking; where is it biased!

RUSH OF THE RETAIL

The regular readers of ‘The Stoic Investor’, would recollect the articles written in March end and early April, where I highlighted to investors that market crash seems to have priced in the risk and intelligent investors will use this opportunity to increase allocation towards equities. Specifically, I got lucky to have timed the issue #10, “The Lighthouse” (read here), just one trading day before the market bottomed (not smart, just lucky). The market recovered well in the following month. However, the move in the last two months has left many, including yours truly, surprised.

The US and the Indian markets have seen a sudden surge in participation from individual (retail) investors. A record number of new equity (DEMAT) accounts have been opened within a short period of time. There is a sharp increase in retail trading volumes. Young investors are enthusiastic about investing in Equity (Robinhood app says average age of investor is 31 years). Indices are close to their all-time highs (Nasdaq even higher). Valuations are higher after considering the downgrades in GDP and earnings. The market narrative is predominantly about the huge liquidity being pushed by fiscal and monetary authorities across the world. The vaccine is assumed to be within reach and next year is expected, by many, to be a ‘normal’ year for businesses. People seem to have forgotten that just 4 months back, many stock markets across the world were hitting lower circuit filters.

Rising markets always attract new investors. However, many compare this level of excitement to the dotcom days. Experienced investors have turned cautious and the neophyte investors are bullish.
HOW DO NEW INVESTORS BEHAVE?

First let's see what impact this new breed of investors can have on the market. The penny stocks can have a huge impact of this liquidity and its already visible. Small and Midcap stocks are also impacted significantly but to the extent that they are considered 'hot' stocks by this group. Select large cap companies may experience price impact; mainly the amplification of an upmove. When a large company announces a positive development and, as a result, there are few sellers, the marginal investor (or group) can amplify the upmove. Under these assumptions, it is important to understand typically how a large number of new entrants behave, as it can have significant impact on one's portfolio.

I referred to some interesting research papers by Brad Barber, Terrance Odean, Robin Greenwood and Robbert Shiller. I have put together a list of characteristics observed in inexperienced/less experienced/young investors:

➢ **Buyers First:**
   Generally, new entrants are buyers first since they are attracted to equities with a view to participate in the rally. I doubt there will be many who open their first equities account to short sell the market. Buying preference can create an upward pressure on the market as more and more new entrants join in.

➢ **Trading frequently:**
   As it is already reflected in the volumes, retail trades have moved up sharply. Unfortunately, a lot of new investors enter the markets with the hope of making quick returns. Their trading patterns show over-confidence. High portfolio churn or frequent trading leads to bad outcomes.

➢ **Hot stocks:**
   A new investor, who has no experience of stock picking, is likely to mimic that has worked (Representativeness bias). Stocks that show sharp increase in volumes and prices attract more attention and as a result many new investors. Hot stocks highlighted by the media also attract attention within this group. Trading platforms also
induce more trading by running screens about what other investors are buying and recommending. Glamour stocks can hence quickly become overvalued.

➢ Trend followers:
Due to inexperience about market behavior, new investors will extrapolate current trends (Recency bias) and end up as performance chasers or trend followers. This can also lead to herding and valuation bubbles.

➢ Amplify the impact of new information:
As mentioned earlier, new investors can amplify the impact of new information about a positive corporate announcement or earning surprise. Studies have shown that experienced investors are less prone to overreaction than inexperienced investors.

➢ Unpredictable during downturns:
Since these investors tend to commence investing during bull markets or market rallies, they lack the experience of handling a market downturn. It is quite possible that they are quite vulnerable to fear or panic.

➢ House Money effect:
The house money effect is the tendency of investors and traders to take on greater risk when reinvesting profit than they would when investing their savings. If an investor makes a profit on the first trade, it increases his/her risk appetite to take more risk in the next one.

The above list shows that ‘new to market’ investors are more vulnerable to biases and prone to follow the herd or the trend.

INVESTING IN THIS MARKET?

For the new investors:
Have a coach/guide/advisor to help you understand investing better. Investing consists of understanding businesses, history, psychology and valuation. Work towards that.
For experienced investors:
I can suggest two approaches, based on the context of this article, from the year 2000 tech bubble. You can take either or a blend of the two.

The Soros Approach: George Soros often says, if he finds a bubble developing, he would like to participate in it. Profit from it on the way up and also on the way down. In early 1999, along with Robertson, Soros' Quantum fund also reduced weightage in tech stocks. However, by September 1999, the weightage was dramatically increased. The quantum fund attracted huge capital as it delivered good returns. By March 2000, the fund stared reducing this exposure and was able to save performance during the downturn.

The Buffett Approach: Warren Buffett's Berkshire Hathaway refused to participate in the bubble. Buffett stayed within his circle of competence and concentrated on accumulating stocks in the consumer and the financials sectors. He missed the roaring tech rally but was also saved from the crash. He took a lot of criticism but later got the praise.

I am not trying to imply that the current market is a bubble. But surely, investors have moved from Panic to Optimism (I won't say Euphoria). Expectations are high and investors seem to be generous on valuations. It is time to be watchful and well calibrated. I would just like to say what Warren Buffett articulated extremely well, “The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.”
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ABOUT STOIC INVESTOR:
The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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