

ANDBANK RESEARCH

Global Economics &
Markets

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Working paper - 68

When should we start shifting our investment portfolio?

March 12th, 2014

ANDBANK /
Private Bankers

Which method is used by investors to learn wisdom?

- Confucius once stated that there are only three methods by which mankind may attain wisdom: By reflection (the noblest), by experience (the bitterest), and by imitation (the easiest)
- According to Will Denyer, financial markets are prone to the third method.(seeking wisdom by imitation). In other words, during bull markets, investors tend collectively to focus in the positives, while in bear markets tend to focus on the negatives (a blatant example of imitation).
- An obvious example of this can be seen today in the contrasting momentum in the US equity markets and the Chinese one.

The analyst pointed out that in the US it seems as if nothing could go wrong: *"If macro figures are bad, the market shrugs it off and attributes this to the extreme weather. When the weather warms, growth data will bounce back pushing markets higher. And if it does not, that will just force the Fed to quit tapering, also carrying markets upward"*

Indeed this could well be the result of imitation (collectively focus on the positives), but not reflection. And this has led to a "heads I win, tails I do not lose" mentality that keeps the equity market going up.

Needless to recall that the S&P have made two new highs during a week where we have witnessed the most serious event of the post-Soviet era, and the most dangerous episode since the Cuban Missile crisis. New highs that have also coincided with a decline in the US-service PMI from 54 to 51.6.



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Another example of “imitation” as the method used by market participants to attain wisdom

- In China, sentiment is just the opposite
 1. Multiples has sunk from a PE of 20x in 2009 to the current 10x (levels seen during the late 1990s crisis and the 2008 global financial crisis).
 2. Chinese equity market has been roughly flat since the last part of 2009 (see the chart)
- Market participants collectively (imitating each other) focus on the negatives: (1) bailout of China Credit Trust, (2) default of Chaori Solar bonds, (3) limits to the Chinese credit markets, (4) limits to the shadow banking, (5) a 2014 GDP target of 7.5% that, rather than instilling confidence, no one believes it for a second
- When in fact, all these decisions may be intended to generate a potential benefit: (1) limits on credit means sustainability and credibility for the sector and the currency. (2) Credibility that will help to keep the RMB’s internationalization, allowing the developing economies to continue industrializing on cheap with Chinese credit, (3) “China is not throwing good money after bad” (says the analyst) because banks are not allowed to grow uncontrollably in credits, and thus (4) China is not ignoring moral hazard. (5) And China will probably hit the 7.5% GDP



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Whatever the reasons that may be behind these policies in China, market participants just focus on the negatives.

Is the market making a mistake by using the method of imitation to attain wisdom?

- Admittedly, market participants may be quite right when sharing an unbridled optimism for the US market, while remaining cautious about China.
- In words of the analyst, investors are perhaps not wrong when focusing just on the positives in the US, and just considering the negatives when it comes to China and thus, it makes sense to continue imitating.
- However, as the spread in relative valuations widens (and as W.Denyer suggests) "*one has to consider whether it is still wise to imitate*". In my humble opinion (and going beyond the analyst), I guess that in such a case it would be better to recover reflection as the method to gain wisdom, and therefore to abandon "imitation" right now.
- **At the end of the day, we all should understand that "imitation" is the easiest process to learn wisdom, and as such, is the least reliable.**
- **With this reflection, we do not mean that it is time now to completely shift our portfolio investments from the US equity market to the Chinese market. Nevertheless, we recommend to start considering this possibility (and only for the bravest, to gradually start the transfer right now).**

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