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ASSET MANAGEMENT
汇信资产管理有限公司

INVESTOR LETTER
January 2021

Dear Investors,

Recently, I did an informal poll asking which of the two opportunities below one would invest in today. Please take a look at the information and see which you would choose.

Annualised return	1-year	3-year	5-year	10-year
Investment X	19.93%	10.19%	12.72%	11.09%
S&P 500	18.39%	14.13%	14.79%	13.84%

Figure 1 Source: Bloomberg; as at 31 December 2020

A majority, over two thirds, of the respondents chose S&P 500 over Investment X.

As I saw the results, part of me went "this is to be expected". Why? One might contend I had presented the information in a way that would have made the choice obvious. Actually, information such as 1-3-5 year performance and line charts are very common if not standard in factsheets for investment products. Hence, I am not surprised that many initial (if not conclusive) decisions are made primarily on such information.

If we had little information beyond this, it is not a surprise to come to such a conclusion. But maybe the outcome would be the same even if I had included a lot more information. Why? It is due to something that is in all of us: Recency bias.

The trap of past performance

Recently at lunch, I overhead a conversation between two persons who were clearly enthusiastic about market opportunities. (I'm not sure if overheard is appropriate; they were so loud it was hard not to hear them.) "I think Stock xxx will go up to $yyy", Person A announced with confidence. As I chewed on my lunch, I awaited the follow-up; maybe Person A had a great thesis which I could learn about. But nothing. The proclamation felt like a debater's closing comments, done not with aplomb but with calm certainty. Person B agreed, adding an anecdote. So here we had two market participants mutually reinforcing each other's view in a game of verbal tennis. Translating this to the market, it would be a cycle of bidding up Stock xxx where higher prices lead to conviction on higher prices.

So, this was recency bias at work; the tendency to favour recent events over historic ones. Why do I single out recency bias when many other cognitive biases can impact investment decisions? Recency bias is one of the most prevalent. Furthermore, it is one of the easiest to fall into, and hardest to get out of. Importantly, because of its prevalence and persistence, recency bias creates mispricing opportunities to capture.

Investing while managing our biases

How can one invest and not fall prey to cognitive biases?

We have quoted "You can't predict, you can prepare" from Howard Marks. The phrase can seem generic and motherhood. Specifically, we feel that one can make educated guesses about possible outcomes. We endeavour to equip ourselves with enough robust data to implement evidence-based investing that allows us to have the conviction to hold the position.

One might guess that the point of the poll was to guide the audience towards Investment X instead of the S&P 500. Indeed, I was proposing that Investment X: Small cap stocks are expected to do better than large cap stocks going forward.

Was this founded on being contrarian for contrarian's sake, or a bet that every underperformance will recover? Not really. First, we start with a concept that is known in investment circles, which may even be termed a "textbook idea". It is the concept that small cap stocks tend to outperform during the recovery phase of an economic cycle, which is where we likely are in now. Figure 2 shows how different investment styles can outperform at certain phases of an economic cycle. The illustration is dated such that we are not using a recent example to prove our point.

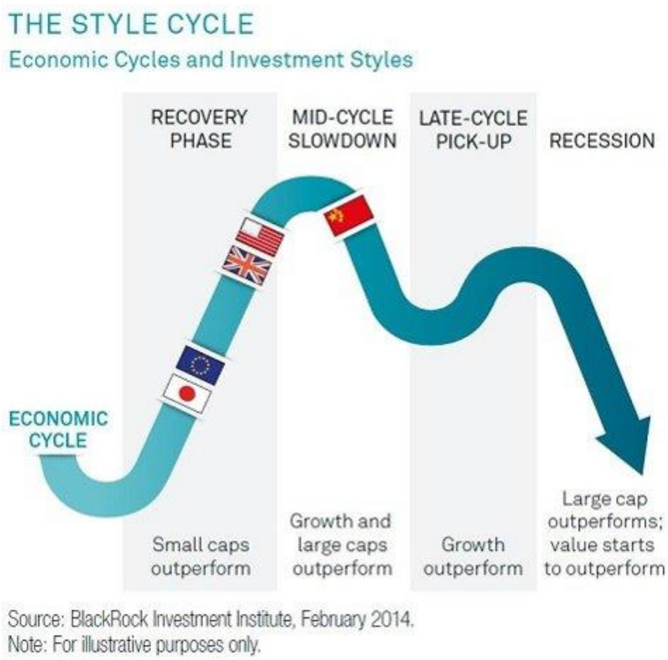

Figure 2 Economic cycles and investment styles.

Expected return is driven by two components: Probability of a win, and size of the win. Beyond the textbook idea above, let's see how much we could make. Figure 3 shows that after market drawdowns, small caps tend to outperform large caps by at least 24%. Hence, an assessment that economies are now recovering, coupled with the covid-19 drawdown, would place small caps nicely for outperformance going forward.

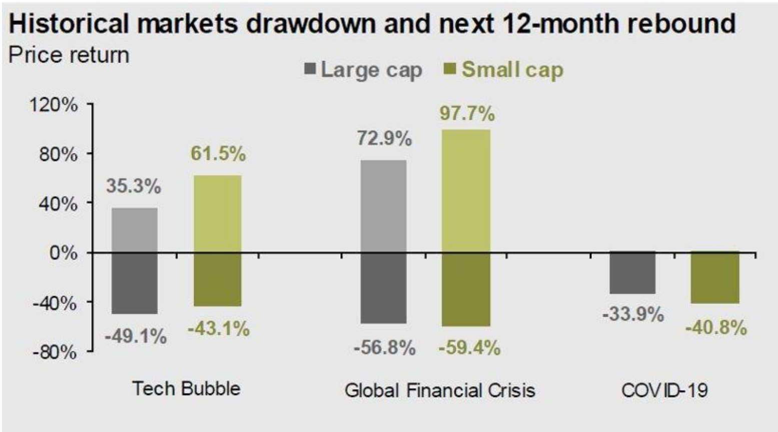

Figure 3 Performance of large and small cap stocks during and after market drawdowns. Source: JP Morgan Asset Management Guide to the Markets 1Q 2021

Admittedly, the data in Figure 3 would not pass any test for statistical robustness. Mark Twain said that "History doesn't repeat itself but it does rhyme." So, let's see if history can reveal some more rhymes so that we can increase the probability of a win. Figure 4 shows the relative performance of small vs large caps, with recession periods shaded in red. Looking at recessions from the 1980s, small caps have tended to outperform during and continued to do so after a recession. We are not out of the current recession yet, but it looks like history does rhyme.

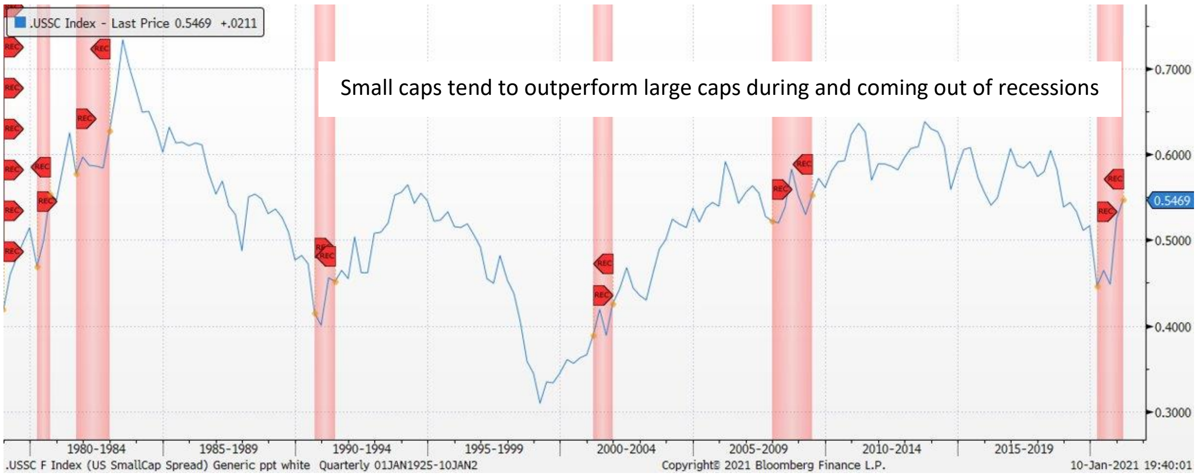

Figure 4 Relative performance of small vs large caps.

A sceptic might ask "What if this time is different?" We ask ourselves that too, which is why we have our FVT process. Figure 5 shows the relative valuation of small vs large cap stocks which are below long-term averages, and recovering from a low. Such valuation dynamic provides a margin of safety. From a technical standpoint, we also see a reversal of the previous underperformance of small caps both in terms of prices and valuation. This at least indicates that the we're not catching a falling knife, which helps improve our odds of a win.

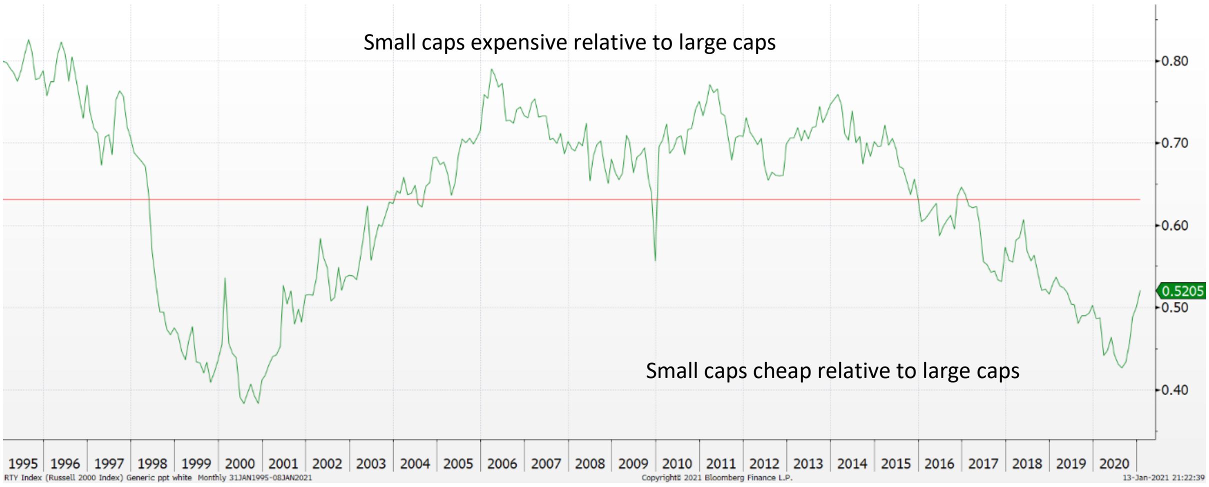

Figure 5 Relative valuation of small vs large caps.

We would not have been able to come to such a conclusion if we only worked with 1-3-5 year performance tables and performance line charts.

- 1-3-5 year performance tables are concise but miss out on longer term patterns. Given that market opportunities have cycles that last longer than 5 years, focusing on 1-3-5 year performance can lead one to miss the bigger picture.
- Performance line chart comparisons contain information but most readers would focus on the endpoint. What if the ending outperformance was coming from earlier effects that are not repeatable? Such anchoring effects are less visible in a line chart (especially for those who already made up their mind). Similar, if the laggard opportunity is on a resurgent phase, it would be overshadowed by the image that its endpoint is lower.

Are we saying ignore past performance? No! Past performance contains valuable information, but only if one considers the context. Just don't look at past performance especially in the way it is typically presented. Some investors get in after something has gone up a lot, we try to get in before it goes up too much.

The trap of past performance: Part II

Going back to the poll findings, another part of me went "why does it have to be this way?" A major consequence is that investors' returns will be much less than that of the opportunity in front of them.

We have used the example of the CGM Focus Fund as a classic example of how investors in a top performing fund can end up with returns much lower than the fund itself. In the case of the CGM Focus Fund, investors actually lost 11% annually even though the fund was compounding at 18%[1]. When I say classic example, I also mean that this was from many years back. Recently, the fund's tumultuous history was revisited. "The CGM Focus Fund, which shot up 900%, got $8b aum, only to drop 50% in '08, now only $300m (despite bounce back & lifetime perf > SPX). Once bitten twice shy..[2]" Essentially, investors had most of their money invested near the peak, and least near the bottom. This means that despite identifying a good opportunity, the outcome is participating more of the downside than the upside. And the pain of loss, accentuated by recency bias, is so great that investors don't reinvest to participate in the subsequent upside.

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[1] https://www.fool.com/investing/general/2013/05/16/why-investors-fail.aspx

[2] https://mobile.twitter.com/EricBalchunas/status/1336777322599485445

Figure 6 CGM Focus Fund and S&P 500 performance

This does not just happen to equity funds with immense volatility, but also to fixed income funds. This week, FT had an article about the Templeton Global Bond Fund[3]. The fund tends to have significant emerging market exposure while its benchmark is a global government bond index focused on developed market government bonds. Figure 7 shows that there were outflows though the fund had not lost money for investors.

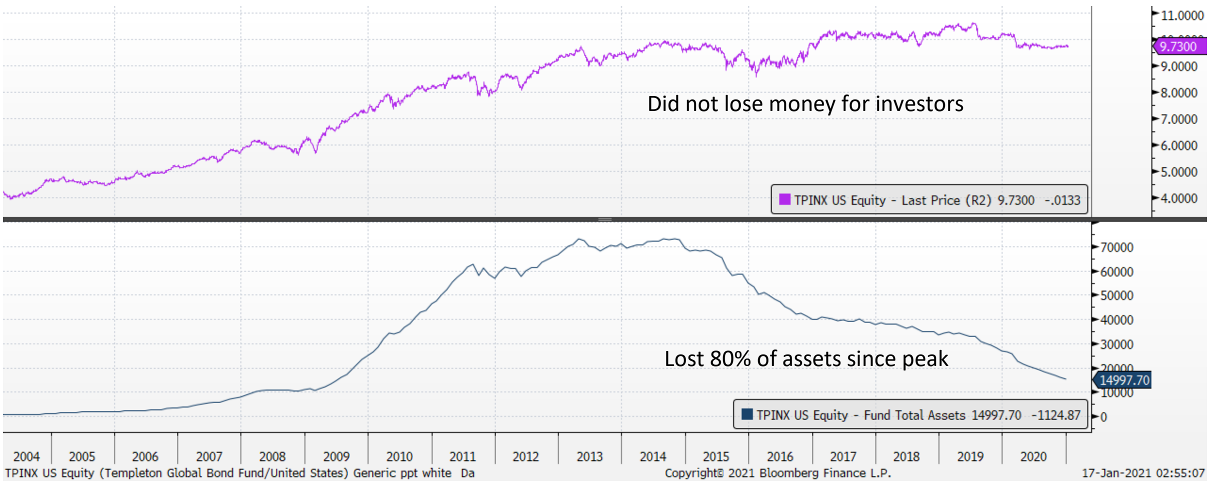

Figure 7 Templeton Global Bond Fund performance and assets

Clearly, investors do not sell only when they encounter losses. What might explain this behaviour? Net outflows started at the end of 2014. Something else happened in 2014. The 5-year annual returns dropped below 8%, something not seen since 2004 (Figure 8). Maybe investors saw past performance annualising above 8% and decided anything below was not acceptable.

[3] Michael Mackenzie (2021, January 14) Hasenstab suffers largest outflow among bond managers in 2020. Financial Times.

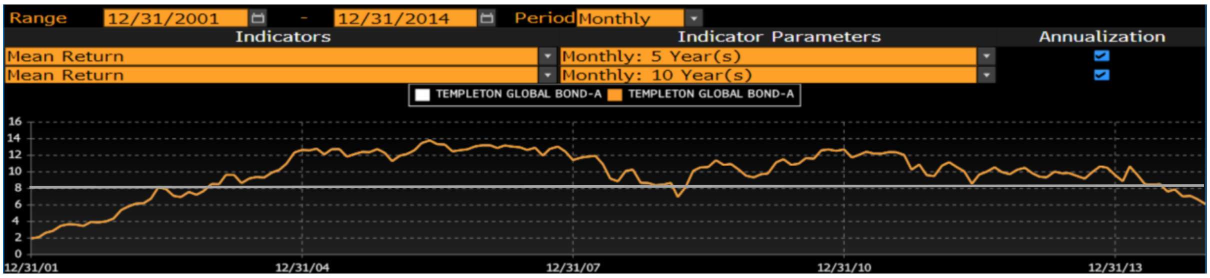

Figure 8 Rolling 5 year returns for Templeton Global Bond Fund

The irony would be that history might rhyme again when the emerging market cycle resumes. The Templeton Global Bond Fund would likely compound meaningfully like the 2000s when emerging markets had a great run for about a decade, and do that at a much lower asset base, similar to the CGM Focus Fund.

It occurred to me that a fund does not even have to lose money to experience dramatic outflows; it just has to disappoint expectations. In a way, this is not a surprise. After all, the same applies to the stock markets too.

As I thought about this, the ARK Innovation Fund which gained 153% last year came to mind. We have seen reverse enquiries about ARK's Disruptive Innovation Fund. Is the interest really in technology and disruption, or in the past performance? Perhaps it is recency bias at play again? Apparently, I am not alone in thinking that history might repeat itself[4]. Again, it is important to know why we are investing, and to be able to hold a position through its inherent volatility.

Let's just say after having done my fair share of FOMO, herding, and hero worship, I've notched quite a number of battle scars which I reflect upon and make sure I don't forget.

While we tend to learn best from our own experience, the meaningful lessons from investing require going through certain ups and downs that are hard to achieve.
Why?

- Market cycles are few and far between. There have only been two in the past two decades, but each one can be painful enough that it threatens to shake the faith of investors.
- Even if we go through the passage of time and cycles, if we do not reflect and improve, we are condemned to repeat our mistakes of the past.

Because of this, we also try to learn the wisdom of others.

Market cycles continue to persist. Cognitive biases serve to get investors on the wrong end of these cycles and put one in a position of anxiety. But if we turn back at every sign of rough sea, we will never hit our destination.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer

[4] https://finance.yahoo.com/news/history-suggests-ark-innovation-investors-172734798.html

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