Quadrant
ASSET MANAGEMENT

Sentiment Risk

QAM Perspectives – October 2015

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"What we anticipate seldom occurs; what we least expected generally happens" - Benjamin Disraeli

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Q3 2015 in Review

The S&P/TSX Composite Index in Canada dropped by 7.8% (including dividends) over the quarter. Materials, energy, and health care stocks declined the most.

The S&P 500 Index finished the quarter down 6.4% (including dividends). After conversion into Canadian dollars, the index had a positive total return of 0.4%. Materials, energy, and health care stocks also led the decline in the U.S.

The MSCI EAFE Index declined by 3.5% (including dividends) in Canadian dollar terms. Similar to North America, the energy and materials sectors were the largest detractors.

The third quarter was characterized by heightened volatility in global equity markets as the Chinese stock market bubble continued to deflate and worries over its underlying economic growth came into question. The U.S. Federal Reserve policy meeting in September was also a source of anxiety in the markets as investors prepared for a potential interest rate increase. Ultimately, due to low inflation expectations and worries over China, the overnight rate remained unchanged.

Yields (interest rates) on government bonds with maturities over 6 years trended down over the quarter, which is positive for prices. Over the same time frame, government bonds with maturities under 5 years showed increasing yields (interest rates) which has a negative impact on prices. Market nervousness caused a flight to quality in the fixed income space causing yields (and spreads) on corporate bonds to increase (widen) with resulting price depreciation on those instruments.

The changes in the shape of the yield curve through the third quarter and the negative sentiment around corporate credit was particularly harsh on the preferred share market.

Quadrant considers the price decline to be an overreaction in a smaller and more inefficient market. Some markets participants have been selling their holdings as if interest rates will never rise again. Sentiment risk showed its fearful side this time around. Panic selling has happened before and, more often than not, it creates a buying opportunity and we believe this is no exception.

Markets at a glance:

Equity Market Total Returns (in CAD dollars)	Q3 - 2015	YTD	1 Yr
Canada (S&P/TSX Composite)	-7.8%	-7.0%	-8.4%
S&P/TSX Capped REIT Index	-3.5%	-1.1%	0.1%
U.S. Large Caps (S&P 500)	0.4%	9.2%	18.8%
U.S. Small Caps (Russell 2000)	-5.4%	6.4%	21.0%
MSCI EAFE	-3.5%	9. 8%	9.8%
Germany (DAX)	-5.0%	4.6%	7.9%
MSCI Emerging Markets	-11.7%	-2.3%	-3.2%

Fixed Income Total Returns (in CAD dollars)	Q3 - 2015	YTD	1 Yr
Canada Universe Bond Index	0.27%	2.31%	5.00%
Canada Real Return Bond Index	-1.47%	0.93%	2.49%
US Investment Grade Index	8.74%	16.50%	23.00%
US High Yield Bond Index	1.10%	10.73%	12.38%
US Treasury Inflation Protected Index	5.74%	13.53%	18.24%

Source: Bloomberg

Behavioral Risk Management: Systemic Risk and Portfolio Management

"*Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof.*" John Kenneth Galbraith

On October 2, the inaugural Quadrant Asset Management Investment Conference, organized by the Asper School of Business, took place at the James W. Burns Executive Education Centre in downtown Winnipeg. (http://news.umanitoba.ca/paying-it-forward-2/)

The Keynote Speaker was Dr. Hersh Shefrin a professor at Santa Clara University. Dr. Shefrin is an internationally recognized pioneer of behavioral finance.

According to Shefrin, the financial community largely ignores the psychology of investing and his main message at the end of his presentation was: ¨Ignore sentiment at your own peril.¨

But what is sentiment in this context? Sentiment is defined by Dr. Shefrin as aggregate market error that creates clusters of optimism and pessimism at very high and very low returns making for overconfident optimists and underconfident pessimists.

Systematic biases in investors' judgments of risk and expected return are manifest within market prices, which in turn serve as a driver of investment returns.

Dr. Shefrin's work is largely based on previous writings of economists John Maynard Keynes and Hyman Philip Minsky. [1]

In his 1936 book, The General Theory of Employment, Interest and Money, Keynes wrote: ¨Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.¨[2]

Minsky argued that capitalism is inherently unstable and that we seem destined to go through predictable cycles, including bubbles.

He said that a key mechanism that pushes an economy towards a crisis is the accumulation of debt by the non-government sector. He identified three types of borrowers that contribute to the accumulation of insolvent debt: hedge borrowers, speculative borrowers, and Ponzi borrowers. The "hedge borrower" can make debt payments (covering interest and principal) from current cash flows from investments. The "speculative borrower" can cover the interest due with the cash flow from investments, but the borrower must regularly roll over the principal. The "Ponzi borrower" borrows based on the belief that the appreciation of the value of the asset will be sufficient to refinance the debt but could not make sufficient payments on interest or principal with the cash flow from investments; only the appreciating asset value can keep the Ponzi borrower afloat.

If the use of Ponzi finance is general enough in the financial system, then the inevitable disillusionment of the Ponzi borrower can cause the system to seize up. When the bubble pops (asset prices stop increasing) the speculative borrower can no longer refinance (roll over) the principal even if able to cover interest payments. As with a line of dominoes, collapse of the speculative borrowers can then bring down even hedge borrowers, who are unable to find loans despite the apparent soundness of the underlying investments.

What to do?

Daniel Kahneman, notable for his work on the psychology of judgment and decision-making and behavioral economics, is the only psychologist to be awarded a Nobel Prize in Economic Sciences. He developed prospect theory along with Amos Tversky in 1979[3]. One implication of prospect theory is

that people whose incomes fall short of their goals are inclined to take great risk as they strive to reach their ambitions. People whose wealth exceeds their aspirations are less inclined to take risk.

The desire we have for certainty and to make order out of chaos causes us to sometimes overlook the reality that life is uncertain and markets unstable. The uncertainty can be scary and it's impossible to get forecasts about the future 100 percent right.

For QAM successful investing means properly managing the risks and uncertainties associated with financial markets and creating customized investment portfolios utilizing time-tested, well-proven investment tenets that take into account specific feelings about taking risk.

Companies with strong balance sheets, competitive advantages, sound economics and reasonable valuations are inherently of higher quality and outperform the general market in more challenging times.

At QAM we remain firm in our belief that inflation protected growth in the long-run comes from holding high quality stocks, while liquidity requirements and stability has to be provided by a cautiously selected fixed income position in the portfolio.

We don't ignore sentiment but instead capitalize on extremes in market sentiment through a proven and diligent investment process.

[1] Hersh Shefrin and Meir Statman (2011), *Behavioral Finance in the Financial Crisis: Market Efficiency, Minsky and Keynes*, Santa Clara University.

[2] Keynes, John M. (1936), *The General Theory of Employment, Interest and Money*, London, Macmillan.

[3] Tversky's peers thought so highly of him that they devised a tongue-in-cheek one-part test for measuring intelligence. The Tversky Intelligence Test was "The faster you realized Tversky was smarter than you, the smarter you were." Malcolm Gladwell (2013), *David and Goliath.* Little, Brown and Company.

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