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AN ODE TO IRRATIONALITY

September 25, 2020

Executive Summary

- Markets globally have been through a roller coaster of sorts and the inexplicable nature of events and market outcomes can make one wonder about the rationality of markets and its participants, especially in the short term

- In this report we have attempted to list various such seemingly irrational events in the markets to understand, classify and perhaps come up with investment strategies to profitably trade, invest or at the very least commit fewer mistakes in such situations, going ahead

- **We have categorized the various types of market irrationalities as:**
  - Irrationality of Inverted Pay offs or Risk Reward
  - Irrationality of Asset Prices
  - Irrationality of ILL Informed
  - Irrationality of Narratives
  - Irrationality due to Moral Hazards

Note: We humbly submit our efforts to unravel markets, be its rationality or perceived irrationality, could well be limited by our own understanding of the same. Sometimes asking difficult questions can be more important than attempting to provide answers

Irrationality of Inverted Pay offs or Risk Reward

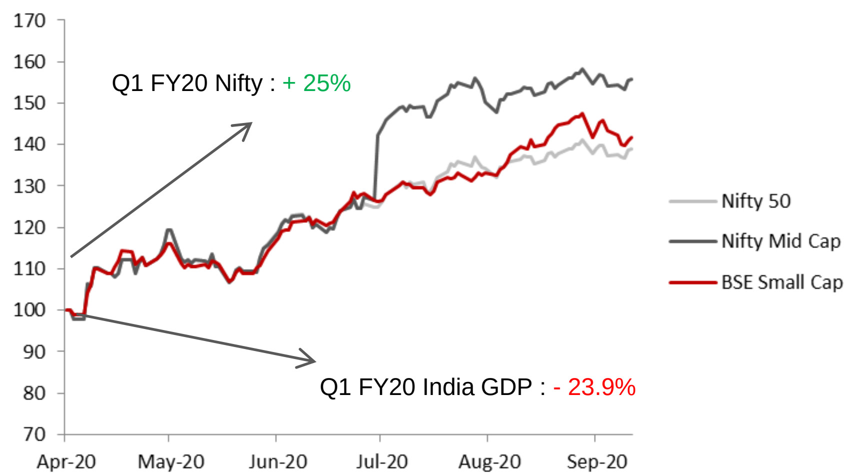
- To recap events in March 2020 as the virus numbers started to climb and economies entered into unprecedented lockdowns there was a synchronized meltdown in the global markets - Equities, Fixed Income, Bullion and Commodities

- **Over the next few months economies especially India continued to contract, and Q1 of this fiscal could perhaps be called as the worst quarter of economic de-growth (virus cases continued to compound as well), however it also coincided with one of best quarters for equity markets**

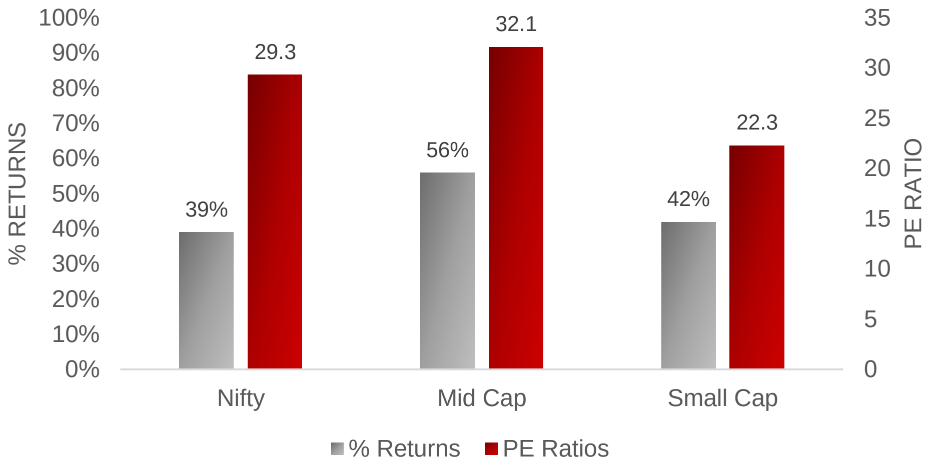
- It's an inverted pay off from an economy - markets perspective, with the Indian Economy seeing the worst quarter (-24%) on the GDP growth numbers, whereas markets bounced back viciously and un-expectedly
  Bulls would argue that this recovery is in line with the forward looking nature of the markets

- **GDP ⬇ Q1 FY 21 : - 23.9% and for full year FY 21 expect to contract by - 11.8% (India Ratings estimates)**

Q1 FY21 : Equity Markets are ⬆



Index Returns & PE Ratios



Index Returns (1st April to 31st August 2020), PE Ratio 12 month trailing as on 31st Aug 2020

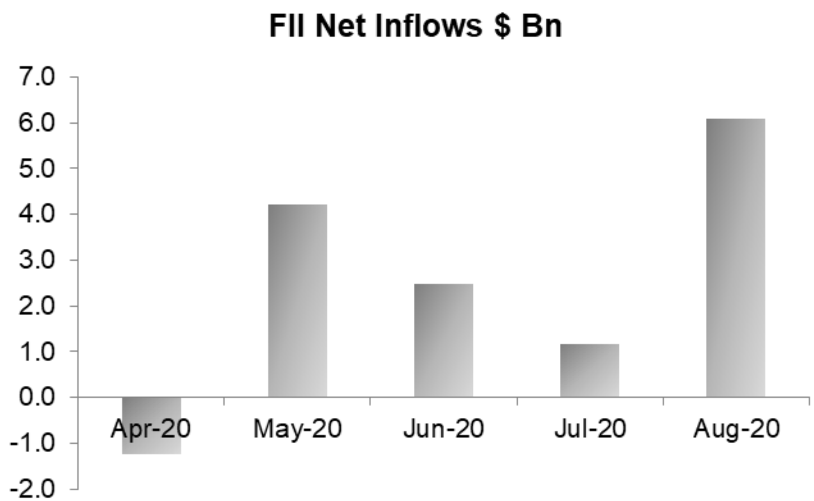
Source: Bloomberg

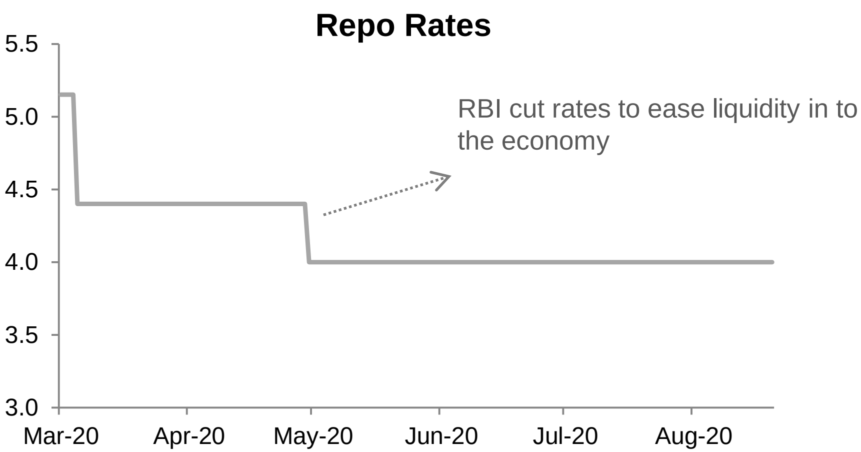
Irrationality of Inverted Risk Reward

- The Liquidity and Low Interest rate arguments

- World economies have entered the realm of unprecedented liquidity and debt to tide over the crisis, efficacy of which on the economy is yet to be ascertained. However there is no denying that it has triggered one of best equity rallies for the markets

- FII Flows into Indian Equity Markets : Cumulative $12 .7 bn from April 2020 to Aug 2020





- Liquidity and low interest rates have helped markets stage a near vertical recovery far ahead of fundamentals or earnings recovery, sometimes seemingly irrational and creating possible illusion of economy and markets moving in the opposite direction

- **What caused the crash in the first place and the near vertical rally thereof - Is it the fear of the unknown and then the liquidity gush, economic green shoots, engineering of events or just irrationality, is a bit of a puzzle to unravel..**

Source: Bloomberg

Irrationality of Inverted Risk Reward

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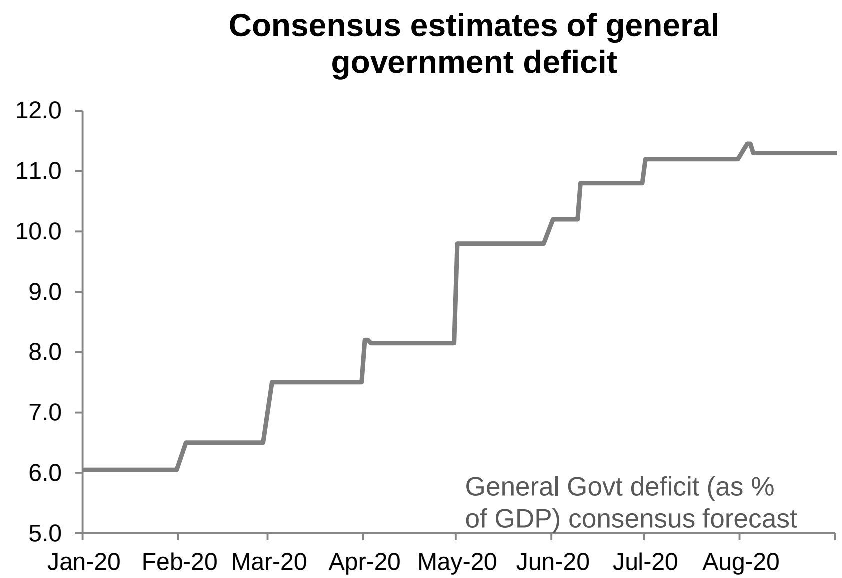
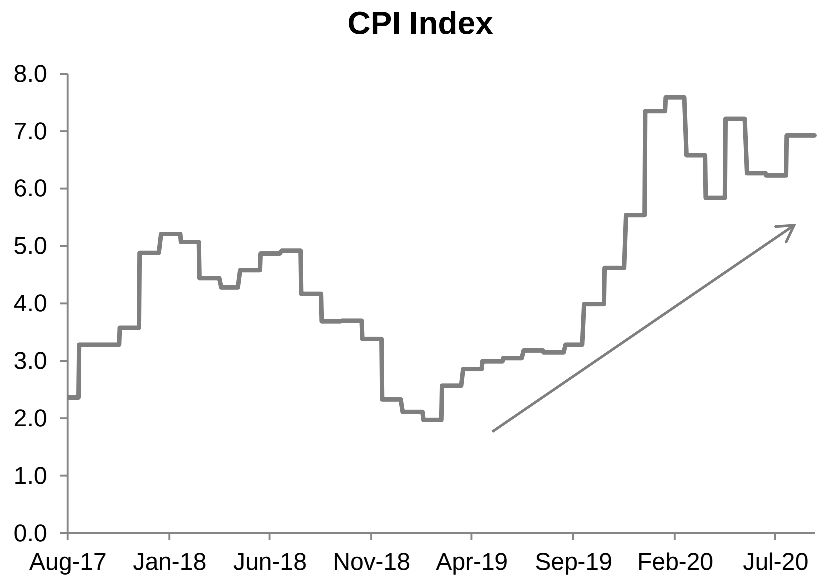
- Sharp recovery driven by flows and deluge of liquidity also could revive old enemies of Indian economy - inflation and high level of indebtness which could potentially put stress on India's sovereign rating



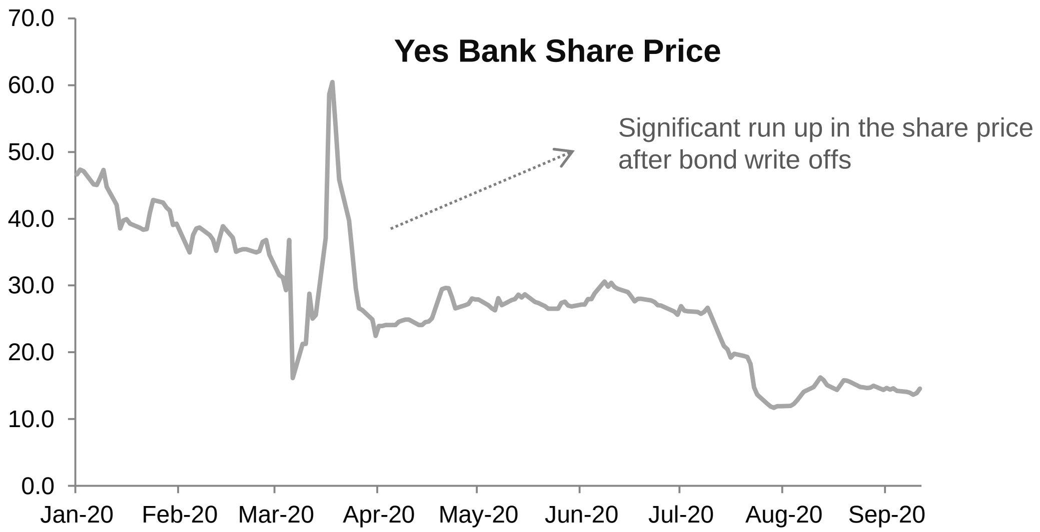


- It could be a difficult balancing act for India with rising indebtness and slowing economic growth to revive especially in the short term, however markets could continue to be buoyant backed by flows and few strong companies taking indices much higher

Source: Bloomberg, RBI, Credit Suisse estimates

Irrationality of Inverted Risk Reward

- Some specific instance of inverted risk rewards
  - **Yes Bank – Curious case of inverted Equity - Debt risk reward**
  - Conventional understanding of Risk - Reward : Equity carries higher risk over Debt or any Quasi Debt instrument
  - However Bond holders (AT1) of Yes bank had to take 100% write offs while Equity still continues to hold value
  - Post Equity infusion and Yes Bank receiving a rating upgrade, if the stock manages to rally, it could well be one such instance where equity holders could recover their investments with bond holders taking 100% write off



- Yes Bank also had price anomaly during FPO (July 2020), when FPO was going under subscribed at INR 13 per share but secondary market price was trading much higher than FPO price during the same period

Source: Bloomberg

Irrationality of Inverted Risk Reward

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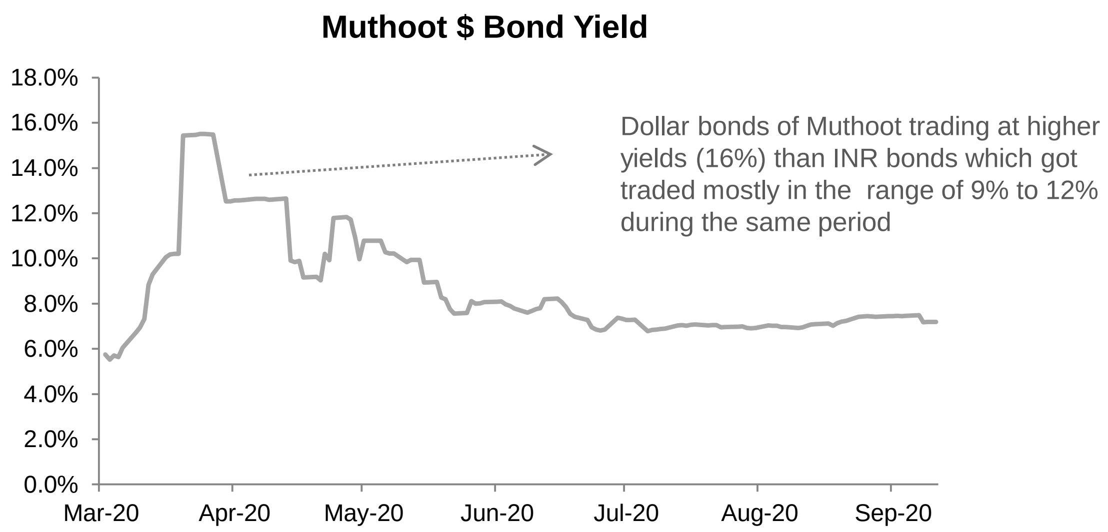
- Some specific instance of inverted risk rewards
  - **Muthoot Finance – Curious case of inverted Dollar vs. Rupee Bond yields**
  - Everything else being equal yields on dollar bonds of Indian issuers tend to trade lower than respective rupee bonds (to adjust for the rupee depreciation)
  - However there have been instances of dollar bonds of Indian issuers trading at higher yields than respective rupee bonds over the past few months



- Possible explanation could be illiquidity in offshore bond markets and unwinding of leverage on some of these bonds leading to spike in yields, however it did present an opportunity for savvy investors to lock in high dollar yields (Mar' 22 paper)

Source: Bloomberg

Irrationality of Asset Prices

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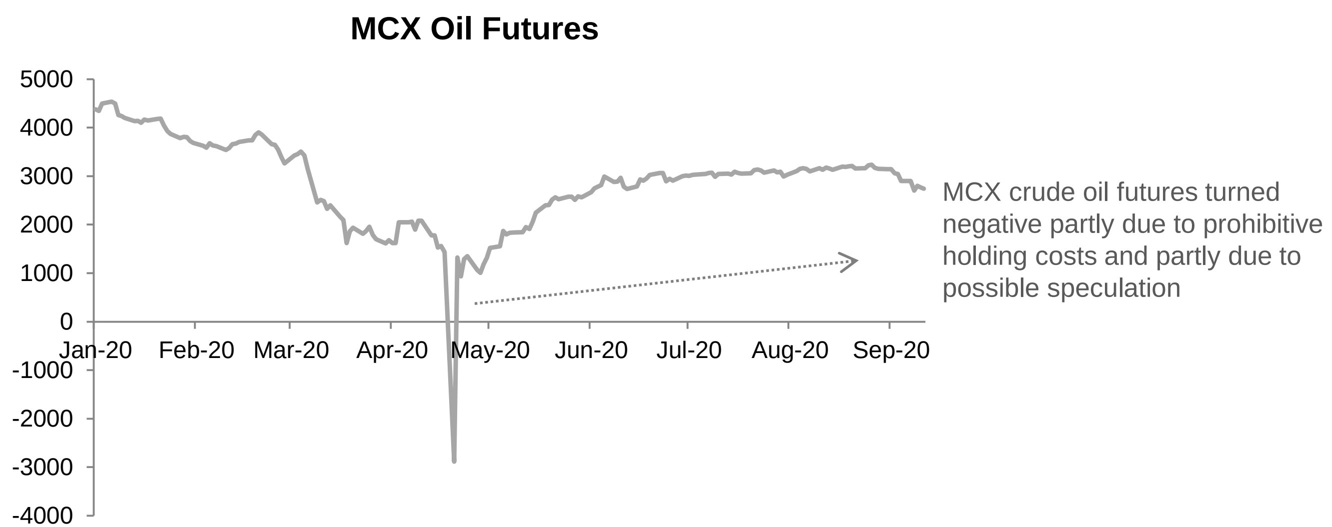
- Important question to ask : Can Asset prices ever turn negative ?
- It's an interesting hypothesis and one could have believed it possible to make a fortune by betting against asset prices turning negative
- Traders did attempt that hypothesis by buying oil futures close to $0 per barrel only to discover asset prices can turn negative due to holdings costs, i.e. when holding costs (inventory) are higher than intrinsic value of the asset leading to backwardation
- It was unprecedented however one may not bet against asset pricing turning negative, even though mean reversion does happen over a period of time



Source: Bloomberg, Prices in the graph as of 1st Generic Futures (current month) and price movement may not be realizable due to roll premiums / discounts

Irrationality of the ILL Informed

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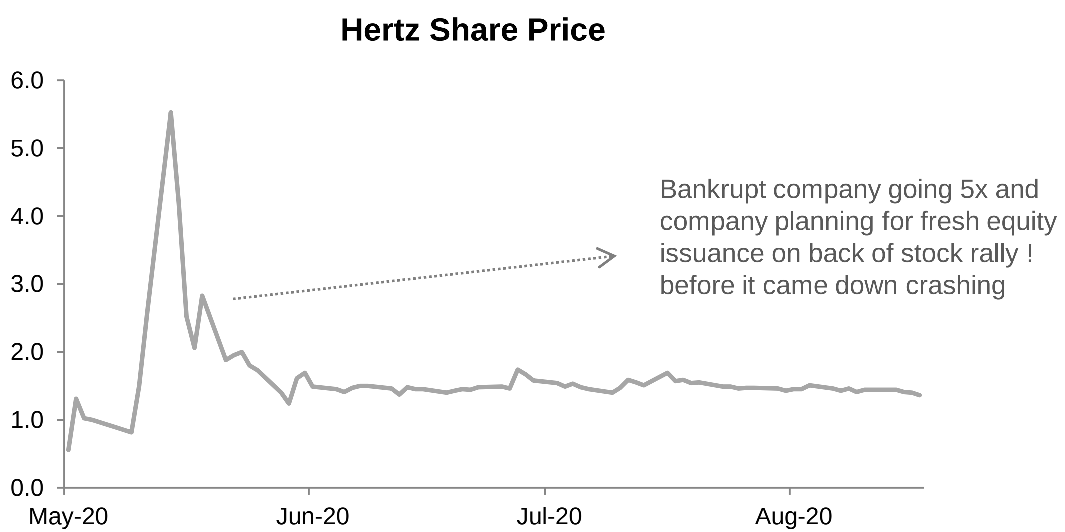
- Markets have seen unprecedented number of new participants entering over the last 1-2 quarters both in India and globally
- Armed with liquidity and lacking experience, new participants do have a tendency to create irrationality in the markets sometimes
- Instances of bankrupt companies going 5x to 10x in prices - Hertz, JC Penney, Chesapeake Energy before falling eventually



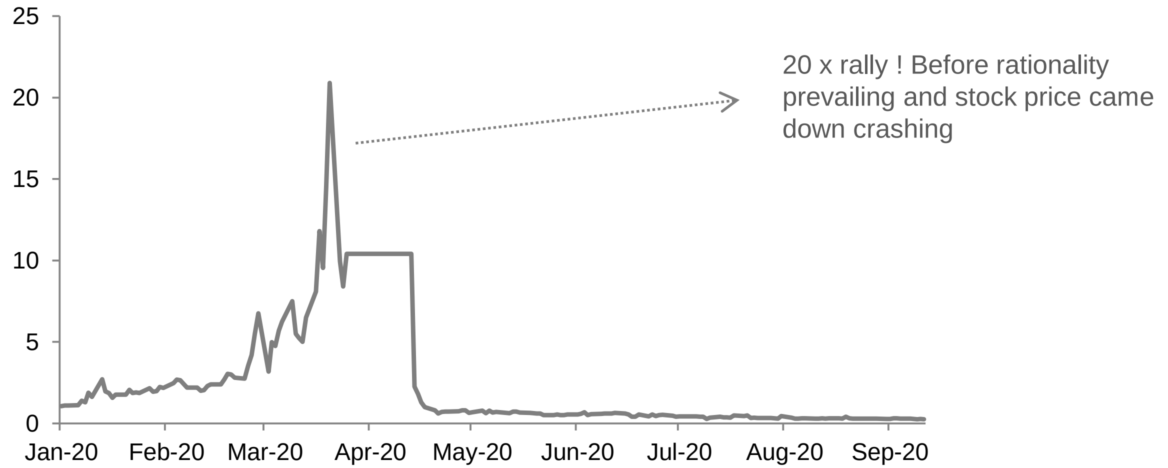
Source: Bloomberg, Forbes

Irrationality of the ILL Informed

- Curious case of Zoom (Technologies) vs. Zoom (Video Communications)

- Zoom Technologies a defunct mobile manufacturing company has seen a 20x rally ! in what could only be explained as investors mistaking it to be Zoom Video Communications which itself has seen only a 5x rally !

Zoom Technologies Share Price



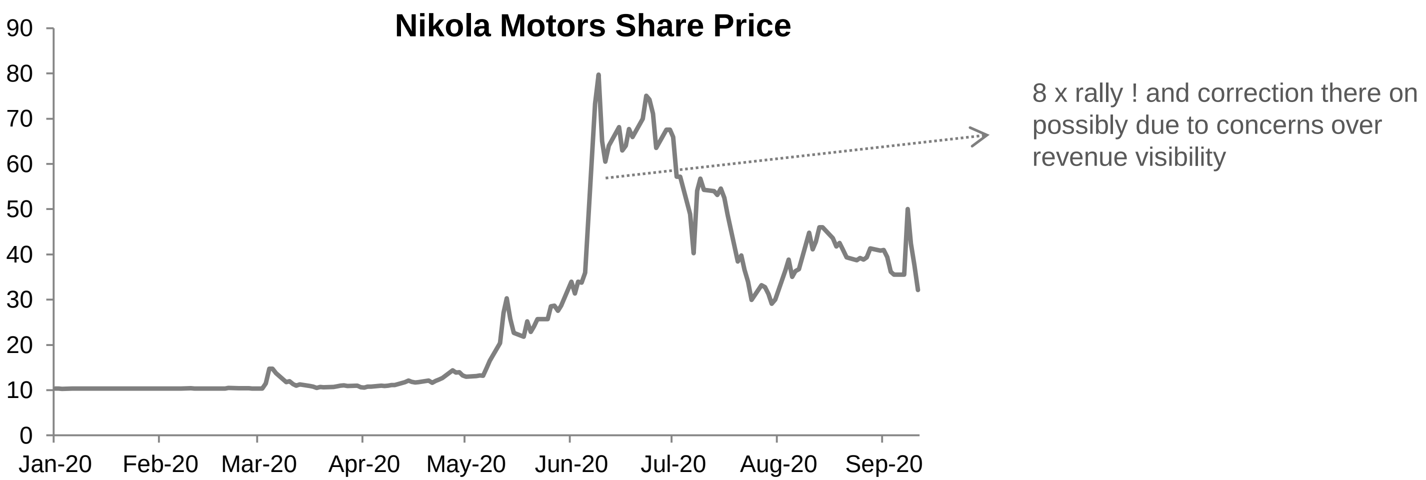
- Indian equity markets are also replete with such example of companies rallying up to 15 - 20x which are either bankrupt, defunct or have zero revenues

- Markets can only be as rationale as its participants

Source: Bloomberg, Forbes

Irrationality of Narratives

- Another key aspect of irrationality is narrative of ***changing the world***
- Whether a claim to change the world is rational or irrational, more often than not is only known in hindsight
- Post pandemic the world has seen some shifts in consumer and technology preferences, however some of these expectations can become irrational over time
- Curios case of Nikola motors - Company worth $23 bn with zero sales !
- Nikola motors expected to revolutionize electric truck and freight markets using hydrogen fuel in US has seen a 8x rally with zero revenues, while jury is still out on this one but one can't help but wonder such lofty valuations for a zero revenue company
- Nikola Motors announced that its founder Trevor Milton would be voluntarily stepping down as executive chairman amidst various accusations being made against the company



Source: Bloomberg, Cnbc

Irrationality due to Moral Hazards

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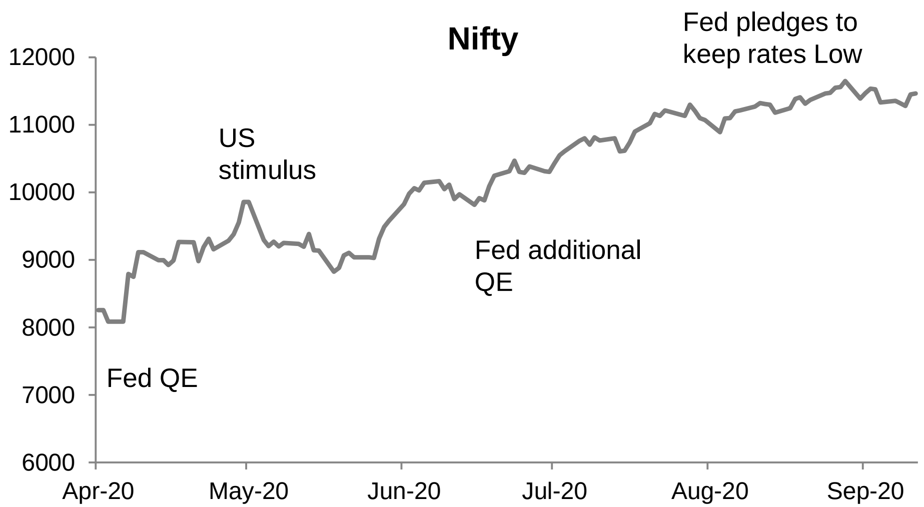
- Its almost a déjà vu' feeling for most investors when an inexplicable or seemingly irrational market moment is followed up by a significant announcement or news flow

- Markets globally especially US seemingly led by all powerful institutions like the Fed. This could create information asymmetry and perceived irrationality for rest of market participants who are blind sided by such policy outcomes



Continuous news flow from Fed & US Government kept the markets buoyant much ahead of fundamentals possibly giving sense of irrationality to the rally

- Potential moral hazard exist if anyone, whether individual or institutions who have access to policy or its intricate understanding stand to benefit, let alone the Fed which has the benefit of setting policy and ability to participate in markets directly or indirectly

Source: Bloomberg

Irrationality due to Moral Hazards

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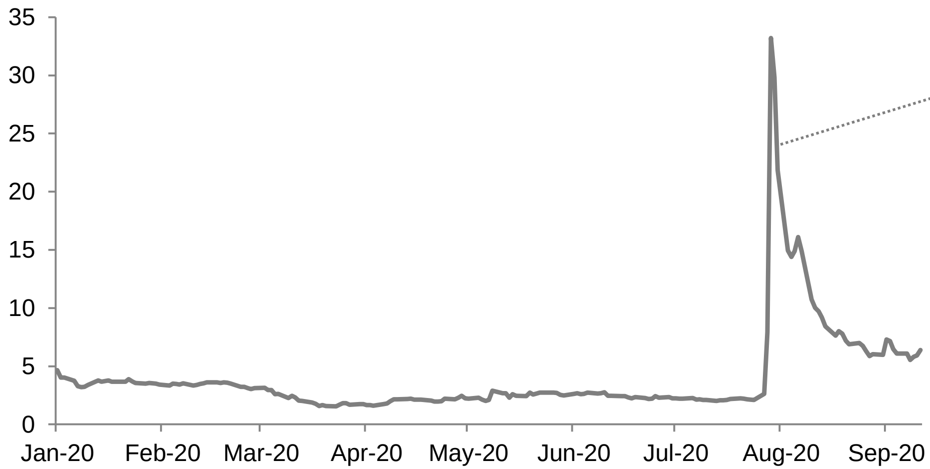
- Some stocks in generic drug and vaccine space have seen irrational price moments before the announcements from the Government or the company themselves

- Eastman Kodak surged 9x in a day with part of the rally happening pre announcement on the deal with US Government for production of ingredients for generic drugs. Currently the price action prompted investigation by SEC against Kodak

Eastman Kodak Share Price



Abrupt rally in prices and correction there of could seem irrational for most investors unaware of the news flow and its implications

- Companies like Moderna and Vaxart are accused of insider actions before announcements made by US Government to be part of Operation Warp Speed (program to develop drugs against coronavirus) or progress on vaccine trails

Source: Bloomberg, Forbes

Observations and Investment Strategy

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- Its difficult to either argue or ignore perceived irrationality, apart from the fact that one should be vigilant against it
- Irrationality especially led by liquidity could stay longer than one can anticipate before eventually reverting to the mean
- Some key guiding posts towards Asset Allocation and Investment Strategy
  - Good to have a long term view on the portfolio, however one should be open and nimble to news flow and events unfolding as they come, anchoring to ones views could lead to portfolio misalignments to new market realities
  - Avoid taking binary calls or going significantly under or overweight on their strategic or long term asset allocation
  - Risk management and portfolio protection to take precedence, albeit at a small cost, which could help avoid permanent loss to capital
  - Evaluate opportunities across asset classes based on relative risk rewards, due diligence and maintain diversification

Observations and Investment Strategy

"Don't try to mine Gold when you can sell Shovels" – Matt Ward

- One can look at overall Asset Allocation and superior investment or trade opportunities instead of necessarily taking calls on short term market directions

  - **Equities** - Liquidity and increased market participants leading to platform Intermediaries and capital market institutions like Stock Exchanges (NSEIL), Depositories (CDSL, NSDL), Registrar and Transfer Agencies (CAMS), Rating Agencies to do well

  - Trading and Long Short Strategies with proven track record and ability to deliver returns across market cycles

  - Special Situation trades with defined and favorable risk reward

  - **Fixed Income -** Mispriced credits and credits going through significant re-ratings, Offshore bonds with superior risk - reward (focus on return of capital rather than return on capital)

  - Well researched companies with strong balance sheets, strong promoters, businesses with tail winds across sizes and rating spectrum

  - **Alternates -** Technology focused companies and funds - Consumer Tech, Edu Tech, Online Commerce, Offshore

Asset Allocation Positioning

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Asset Allocation Relative to Strategic

- Equities
- Neutral Weight Large Mid Small
- O/W long short and capital protected strategies
- Overweight Growth
- Debt
- Underweight Arbitrage
- Duration for tactical investment in medium / long term g-sec
- Near maturity high spread instrument
- Corporate Bonds for accrual / positional trade
- Short maturity credit to lock in carry
- Neutral weight Gold
- Physical Gold, Gold Bond, Gold ETF

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