THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

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By Nimesh Chandan

The Talk Market

"We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first."
– Charles MacKay, Extraordinary Popular Delusions & the Madness of Crowds

People think and understand the world through narratives. Leaders in politics, government and business use stories to explain what is happening and to inspire change. In every facet of life, stories influence human behavior.

In the book Sapiens, the author Yuval Noah Harari talks about the history of humankind. In just 100,000 years (which is quite short in evolution terms), Homo sapiens in a bid for survival competed with other animals on earth and came out on top to become the masters of the planet. At an individual level, human beings are not much different than the chimpanzees. However, collectively we are superior to not only other animals but also the other human species that existed before us. The secret of such power is our ability to cooperate flexibly in very large numbers.

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The question is what enables human beings to cooperate (even with strangers)? Harari says, it is our ability to create fictional realities (Narratives). Through our cognitive abilities of learning, remembering and communicating, we were able to understand and protect ourselves from dangers. Through our imagination, we were able to create abstract or fictional realities. Legends, Myths, Gods and Religion became part of our history because of the ability to imagine and create effective narratives. As long as everybody believes in the same fictional

reality, they cooperate effectively. They will follow the same laws, share same values and act in sync.

Our stories and narratives have helped us survive during the ancient times. And they still continue to play an important role in our everyday decision making. While disciplines like Anthropology, Political Science, History, Psychology and Sociology give adequate importance to the role of narratives; Economics and Finance have lagged far behind. Narratives influence our decisions on how and where to save, spend and invest. However, economic models have not acknowledged this important role of narratives.

NARRATIVE ECONOMICS

Last August, Nobel Prize winning economist, Robert Shiller released his book, Narrative Economics: How stories go viral and drive major economic events. He describes narrative economics as "a study of the spread (and dynamics) of popular narratives (the stories), particularly those of human interest and emotion, and how these change through time, to understand economic fluctuations".

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Shiller uses a simple example of a recession: A recession is a time when many people decide to spend less or to postpone their investments. But are these decisions a result or a cause of a recession? Narratives about a forthcoming recession can become contagious and lead people to take decisions that ultimately cause one.

Another example of contagious effect of a narrative is bitcoin. Though there is no estimate of a fundamental value of a bitcoin, the price soared on the belief that it is the currency of the future and hence extremely valuable. An added excitement is the story about its limited supply and freedom from government or central bank controls.

Shiller compares the spread of a narrative to a spread of a disease epidemic. They both have a susceptible population, a contagion rate and a recovery rate. There are many narratives at work at any given point in time in an economy and in the markets. The idea spreads when more and more people are talking about it. At some point in the life of the narrative, it is either falsified or replaced or simply stops spreading which can be termed as the recovery rate. The narrative continues to remain in force till the contagion rate remains higher than the recovery rate.

CORONAVIRUS

The sharp volatility in the global equity markets recently was the result of the narrative of the coronavirus. As the virus and the news spread, there were many theories that sprang up about how it can have disastrous impact on the world economy. The ingredients of the story were quite attractive: 1) China is a large part of the global economy and an important trading partner to the world 2) The virus was spreading faster than expected beyond Hubei province 3) The number of fatalities crossed the ones during SARS quite quickly.

Investors were worried about global economic growth. Commodities were the first and the hardest hit victims of the selloff. These stories were quickly topped with some parts of the media doubting the actual number of people affected as declared by Chinese government. Add to that, the conspiracy theories about biological warfare. Clearly the stock markets lost billions of dollars in value within a few days.

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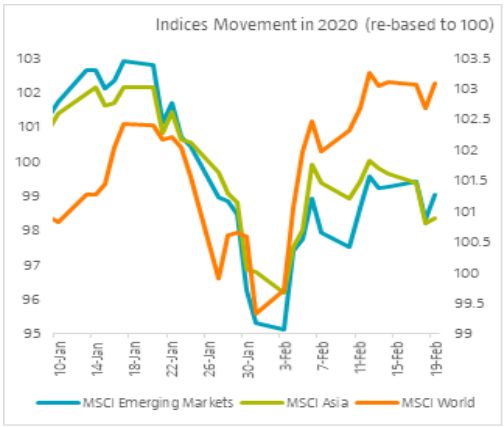
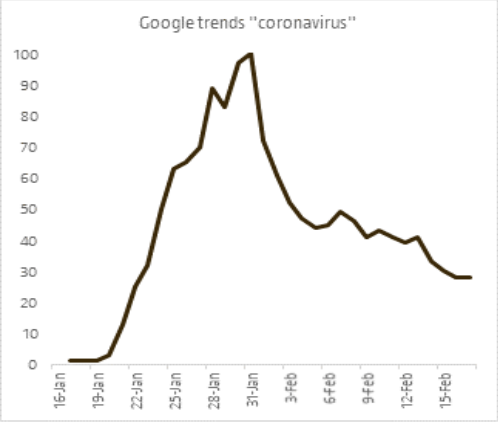
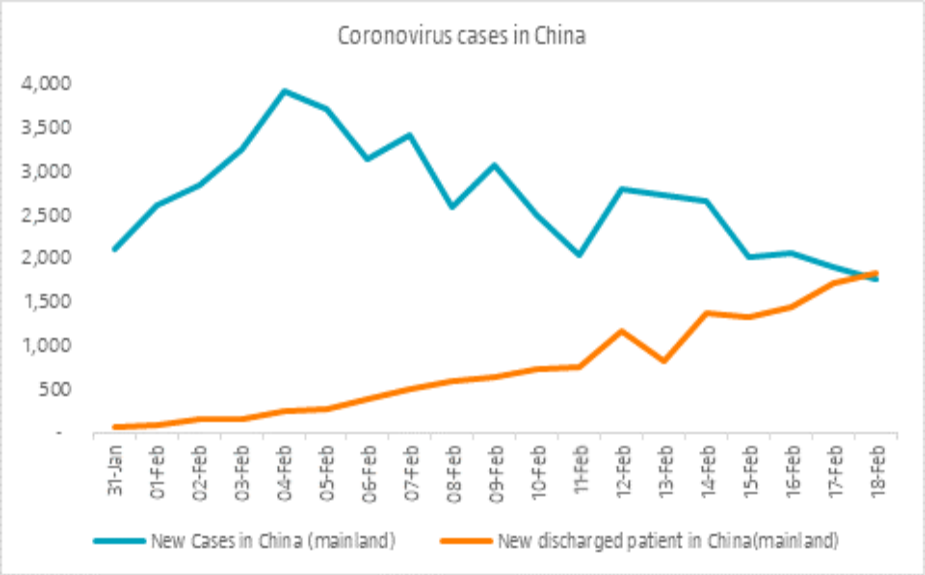
As you can see in the charts below, as the google search for coronavirus or the interest in the coronavirus kept rising, the markets kept moving lower. They almost look like a mirror reflection! Government and central banks began to assure investors of additional liquidity in case the economic growth slipped due to the epidemic.





*Google Trends numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means that there was not enough data for this term.



*the new cases for 12th Feb & 13th Feb have been normalized by taking previous 6-day averages to avoid impact from change in methodology

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However, by the end of January (or the beginning of February) the interest as represented in the Google search data started receding. The recovery rate of the patients also started rising (refer to the discharge rate from the hospitals). The narrative in the papers changed from "spread of virus "to "we will be ok". Worries of long drawn battle with the disease changed to "quick recovery". And the uncertainty on impact on economic growth changed to comfort of the liquidity injection. Across the world, the equity markets recovered. In fact the MSCI World index which represents the developed markets rose to a level higher than pre-corona virus. Investors believed that these markets were anyway least affected plus they are assured of the liquidity bonus.

How should an investor react?

It is extremely important for the investor to be aware of the impact of non-economic forces on the markets. A smart investor is the one who is not only equipped with the right data (about economies, markets and companies), but also the understanding of the behavior of the crowd. Narratives have a profound impact of the economy and stock markets. Unfortunately, they can't be modeled in a quantitative equation. It is only by being aware of its existence and knowledge of its nature that investors can use it to their advantage. Know the stocks and the talks!

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Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

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).