



Market Commentary
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English Version

Insigneo Weekly Dispatch

The Rationality Behind Market Irrationality

Get guidance on investments, and the major structural factors behind your clients' portfolios.

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The Rationality Behind Market Irrationality

While market behavior is the aggregation of rational expectations where asset prices reflect all available information, it does not always deliver efficient asset pricing.

The combined actions of different market players trying to optimize different goals, purposes, and time frames can create unintended asset mispricing consequences, thus creating market dislocations.

Business cycle after business cycle experience shows that efficient investing, whether to preserve or to create capital, is driven by carefully assessing the intrinsic value of the assets in the portfolio instead of just taking investment decisions based on short-term market news.

Amid discussions surrounding market outlooks, a common question we receive from clients is “why do markets act irrationally at times?” The efficient market hypothesis states that asset prices reflect all available information. This is a fundamental, yet much debated, concept in finance that does face some challenges stemming from behavioral economics and empirical anomalies. While research leans toward market efficiency, ongoing studies and real-world events continue to question its universality. So, it remains a dynamic field of inquiry. Specifically, we want to prod further by asking, “if markets are truly efficient, what information could the market possibly hold, not only to act against “reason” but, even more dauntingly, the perceived consensus?”

While there is no single or definitive answer, the forefather of macroeconomic thinking, John Maynard Keynes, once gave us a fair warning: “Markets can

remain irrational longer than you can remain solvent”. Back to our philosophical question: are financial markets rational? Why do they behave, rather frequently, contrary to the opinion and assessment of the greatest, most well-informed minds in the industry?

Is there more logic than meets the eye in market behavior? Or is it perhaps not about a lack of logic, but rather the net effect of rational decisions taken by economic agents, serving different purposes and time frames, which, when combined, can generate unintended consequences? I know, I may have made things far more complicated than needed, but there is a light at the end of the tunnel.

John Nash was one of the pioneers of governing dynamics. Game theory has studied these seemingly irrational situations for decades to understand how the combined effects of our own decisions, along with those of others, can influence outcomes, often making them look suboptimal or even irrational. Let us think about a few examples to help put things in perspective.

The goal of a long-term investor, using a time horizon longer than a decade, should be to select good quality companies in which to invest, either by buying equity or debt, as a way to increase or preserve wealth. Consequently, not only should the investor be less worried about the current market environment, but they should similarly deemphasize (or disregard) short-term uncertainty or volatility. Time after time, history has proven that investing in good quality businesses leads to wealth creation.

On the other hand, a more speculative investor that is trying to benefit from tactical market movements, or businesses, such as financial institutions, could use financial leverage as a key component of their business strategy to maximize returns. In doing so, they will be far more exposed to short-lived risk and vola-

tility than a prudent long-term investor, where even small adverse market changes can have a severe effect on the market value of their holdings, potentially putting them at risk of bankruptcy.

Now, imagine you are the Head of Risk Management for a major Wall Street firm. You likely fare well and have a good salary, which means that you also probably have a personal account where you are saving for retirement. Confronted with the severe market volatility we have witnessed over the last few weeks, your behavior might look rather contradictory. When working as a risk manager, you have instructed the trading floor to quickly reduce risky assets to mitigate balance sheet volatility and bankruptcy risk. In other words, you reinforced market forces pushing prices further down. However, for your personal account, since you do not expect short-term market behavior to persist indefinitely and you do not use leverage, you have remained invested, or perhaps even used the opportunity to buy companies you have been monitoring for some time, waiting for the opportunity to invest at a better price (i.e., if Tesla was great last year, purchasing it 50% cheaper might be a once in a lifetime opportunity).

Are those decisions incongruent? They are not. It simply means that, while acting rationally and confronted with two different optimization problems, two very rational, though different, decisions were taken.

Let us analyze another example. A short-term trader working for a financial institution does not aim to identify and profit from long-term market trends, but rather to take speculative positions to profit from short-term market dislocations and overreactions by taking long or short bets on risky assets. This type of strategy requires adherence to very tight risk limits to avoid severe losses, beyond the risk budget assigned to the trader. Over the last few weeks, if the trader

was short the market, then the trader has likely made substantial profits. Even if the year-end expectation is for the market to continue trending down, two rather incongruent paths will most likely unfold. First, given the risk of important news released over the weekend the trader will likely close short positions on Friday to avoid remaining exposed to weekend market volatility that may push prices up. Second, after several days of heavy selling, reaching levels only seen a few times in financial history, the short-term trader will most likely close the short position and open a long position to profit from “buying the dip” strategies or “short-squeeze” market reactions. Once again, this would push market higher against the year-end expectation.

What is even more interesting is that the same person might still have a personal account, holding long positions bought a long time ago at lower prices than today’s, even after the selloff. Provided with the expectation of a bright long-term outlook for the holdings in their portfolio, the investor will most likely remain invested in these good quality businesses or use market volatility to strengthen those positions.

Before we end, one final example. Strategies such as market neutral long-short, to some extent, do not even care about the overall market direction but rather the relative performance of the securities used to implement the strategy. A hedge fund taking a long position in General Motors and a short position in Ford is not trying to establish the overall market direction. The assumption is that, based on their analysis, General Motors should, in relative terms, outperform Ford. By taking a long position in GM while selling short Ford, the investor can make a profit on the performance differential between the two firms,

regardless of whether the overall market moves up or down. Even while having a negative market outlook for the next 12 months, the investor will still ‘irrationally’ enter a long GM position while taking a ‘rational’ short Ford position, where the success of the strategy depends, ironically, on the relative outperformance of the so-called irrational side of the trade.

What should be clear by now is that financial markets combine millions of rational decisions, and in doing so, will repeatedly and temporarily fall into the classical prisoner’s dilemma.

What, then, is the best way to efficiently approach decision making while acknowledging that suboptimal outcomes are part of the journey to long-term wealth creation? We will leave that conclusion in the hands of the best investor in history, Warren Buffet:

“I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful.”

“Games are won by players who focus on the playing field -- not by those whose eyes are glued to the scoreboard.”

“Buy a stock the way you would buy a house. Understand and like it such that you’d be content to own it in the absence of any market.” ■



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