Philequity Corner (July 13, 2015)
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A Classic Case of Greed and Fear

The course of human history has been shaped by our many emotions. However, none have had a larger impact than the 2 most powerful emotions of all - love and hate. In the stock market though, love and hate do not reign supreme. The emotions that can bring stock prices to stratospheric heights as well as pull them down all the way to oblivion are actually greed and fear. In the stock market, these 2 emotions govern the cause & effect of many actions.

150% bull run in 1 year

Over the past few weeks, traders monitored every development in Greece. Now, the world is enthralled by the spectacular rise and fall of China's stock market. Last year, the Shanghai Composite index was just trading at the 2,000-level. After rising 150% over the course of a year, this blistering bull run ultimately peaked at 5,178 (see chart below).

Shanghai Composite index - 1-year chart

Greed, Herd mentality, Borrowed money

The reason behind the sweltering pace of the rally we saw in China is greed coupled with herd mentality. 100 million retail investors chased whatever stock is moving in hopes of making a quick buck. In China's case, however, this bull run was fuelled by 2.3 trillion yuan ($370 billion) worth of margin financing, or borrowed money. These people bought stocks on borrowed money to satisfy their greed, with some even pledging their own homes as collateral. To make matters worse, more than half of new investors did not even have a high school diploma. In other words, Chinese stocks reached extremely stretched valuations on rampant borrowing by people who purchased risky assets despite not being equipped to make proper investment decisions

Stock market plunge, 1/3 of value lost in 3 weeks

Stretched valuations, extreme bullishness, high leverage, farmers preaching about trading – these were the hallmarks of a bubble in the making. When the MSCI announced that it was not including China A-shares in its benchmark index, the stock market began to unravel. 1 week after the MSCI announcement, the Shanghai Composite was already down 14%. Over the next 18 trading days, more than half of listed companies (1,331 stocks) were suspended from trading to arrest mounting losses and yet the index still fell 33% from the peak.

Fear of losing everything

The reason behind this sharp drop was fear – the fear of losing everything they have. Being overleveraged and faced with accelerating portfolio losses, people went rushing for the exits. In fact, there were many reports of suicides over mounting losses in the stock market. What happened to China was a classic case of greed and fear. Greed made people risk everything to make money. Fear then created panic as they were about to lose everything and more.

China to the rescue

As the market was falling, traders looked to the Chinese government for help. Although history shows that central banks and governments have intervened to prop up their stock markets, as was the case with the US and Europe, China is on a different level. The authoritarian regime acted quickly, albeit clumsily and in an unorthodox manner. To prevent a full blown stock market crash, the government implemented these extraordinary measures:

1. Reserve requirement ratio (RRR) and interest rate cuts
2. Suspension in the declaration of IPOs
3. Freezing of trading in more than half of listed stocks
4. Ban on stake sales of major shareholders (5% stake and above) for 6 months under threat of imprisonment
5. Relaxation of regulation on stake increases by major shareholders and senior management
6. Share purchases by the state pension fund
7. Encouragement of corporate share buybacks
8. Increase equity exposure limit of insurance companies
9. Lending to 21 major Chinese brokerage firms to invest 210 billion yuan in blue chip ETFs
10. Decrease in stock transaction fees
11. Easing of rules on margin financing
12. Investigation and arrest of short sellers who were accused of market manipulation

Panic selling spills over to HK, Asia

These measures are not only extraordinary, but also unprecedented. Imagine a situation where more than half of stocks in our stock market are frozen. Unfortunately, these measures had unforeseen consequences. Because many investors in Chinese stocks could not sell their shares, they resorted to selling and shorting HK-listed Chinese companies and China ETFs (such as 2828, 2823 and 2822), causing the Hang Seng index to follow Shanghai's drop and fall 6% in one day. This rattled other Asian markets which experienced corrections as well.

Bottom reached?

While it remains to be seen whether China's government can put its country back on a stable growth path, the measures implemented to prop up the stock market and restore investor confidence have already made an impact. As of closing last Friday, the Shanghai Composite is already up more than 10% above its low. Margin financing is also down 36% to 1.6 trillion yuan. If margin financing falls another 40%, Goldman Sachs estimates that margin balance to free float market cap in China would be similar to that of the US. Although these are not clear signs of a bottom, it is clear that the Chinese government will do everything in its power to stabilize the stock market.

Liberal arts in the stock market

In making investment decisions and managing a fund, having an education in economics, finance, accounting and mathematics are very important. However, having a background in the liberal arts subjects like literature, history, philosophy, psychology and sociology is also helpful in the stock market.

For instance, the seemingly reckless bravado of Greeks to vote "No" in a risky referendum would be given better context if one knows of their history, philosophy and literature. As for the sharp ups and downs of China's stock market, these can be explained by psychology and sociology. Clearly, the stock market is more art than a science, with liberal arts playing an important role. In fact, our fund manager told Fr. Jett Villarin, President of Ateneo, that the discipline of management engineering and math is important in his career. However, it was also the strong liberal arts background of Ateneo that played a big role in his success in stock trading.

Navigating through a volatile market

Since these are very turbulent times, the topic for the investors briefing will be how to navigate through a volatile stock market. On the same day, we will be launching a book entitled "Opportunity of a Lifetime" authored by our fund manager, Wilson Sy. The author hopes the book can be used as a guide on how to invest properly. More than giving tips, our fund manager wants to teach people how to invest through past experiences and lessons imparted in this book. We are inviting all Philequity investors to the shareholders meeting, investors briefing and book launch on August 1, 3PM at the Meralco Theater.

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