Popularity And Beauty Contests

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"The markets are moved by animal spirits, and not by reason"
John Maynard Keynes (1883 -1946), British economist, whose ideas fundamentally changed the theory and practice of macroeconomics

Keynes once famously remarked that your personal preferences and tastes are not going to be of much use in determining which contestant is likely to win in a beauty contest. One should instead asses the degree of "popularity" of the contestants as perceived by the panel of judges who will be choosing the winner. He used this as an analogy to the stock markets, illustrating the importance of collective sentiment in influencing the trajectory of the markets themselves. This, of course, ran contrary to the "rationalists" who firmly believed that the price level of the stock market is basically an aggregate, present value sum of the future cash flow streams of its constituents, and that any deviation from that "intrinsic value" would be temporary.

Keynes made lots of money tracking the collective sentiment of the "herd", especially in the way in which it helped him determine if markets were in a bubble, and even though he didn't have anywhere near the breadth of shorting instruments available today, he was able to make enough of a difference by just adjusting his portfolio exposure to the markets. Stocks do have an intrinsic value around which the price tends to gravitate, and although this value can be quantified to a decimal point, its foundations, most notably the future cash flow stream and the discount rate applied to bring it to the present, is, to a large extent, sentiment[1] driven. It goes to say that if the foundations lie on wobbly ground, who can say for sure if a stock is fairly priced or not at any point in time?

If the intrinsic or fair price value of an investment is tainted, using it as a reference point to assess the valuation of the investments will also be arbitrary. These risk premium distortions can lead to costly investment policy mistakes in situations where entire markets are warped by the anomalies. Second guessing the "herd" will also not get you very far in such instances, knowing that it is close to impossible to predict in advance those "tipping point" moments when sentiment abruptly changes from one state to another. Still, if by gauging sentiment we are able to determine with even limited certitude whether or not the markets are in a bubble, like during the dot com folly of the nineties, that in itself should be considered a good start.

One major key may lie in "popular economic narratives" that tend to cluster around topical issues such as the degree of corruption in a region, real estate booms and busts or the technology-driven employment displacement threats that are becoming all too common. These narratives that are thought to play a significant role as influencers of human decision

[1] Future cash flow projections are based on assumptions that are overly simplified because there are so many variables that can affect the trajectory of those cash flows that it is impossible to model them in any reasonable manner. This is also why stocks sometimes experience sharp swings as those cash flows are adjusted to reflect newly available material information.

making across time[2], are in constant flux, expanding or contracting much like infectious diseases do, requiring skill sets similar to those of epidemiologists to track them. Measuring the degree of "popularity" of something is a clear departure from the neoclassical, fundamental approach, borrowing instead from the newer behavioralist playbook, which means that it brings with it the numerous effects of cognitive biases and errors (prospect theory, loss aversion, framing, mental accounting, overconfidence).

If we use risk premiums to price investments and given our natural aversion to risk, everything else being equal, "riskier" assets should be priced lower and with higher expected returns than assets that are perceived to carry lower relative risk. Since we now know that we certainly don't behave rationally all the time and that all else is almost never equal, however, means that the Capital Asset Pricing Model or CAPM[3] that measures non-diversifiable market risks, and the risk premiums from which it is derived, may not be as reliable as once thought. Maybe by integrating a notion of "popularity" can we extract a more accurate measure of the intrinsic value of a security? This is exactly what Roger Ibbotson and colleagues set out to find out according to a recent publication of theirs[4].

Ibbotson proposes integrating a broad definition of "popularity" measures that include rational as well as irrational elements into the classical CAPM, with the hope that this would lead to a more accurate measure of the intrinsic value of an investment. Popularity in this instance would be antithetical to risk, and therefore a negative contributor to expected return. An exhaustive time series analysis of the markets revealed that companies that had well established brands, high barriers to entry, steady earnings or historically low tail risks - all characteristics that contribute to "popularity" - tended to perform poorly later on compared to those that didn't have these properties. In other words, "popularity" appeared to chip into risk premiums, markedly compressing expected returns.

It may appear surprising that "popularity" which is synonymous with being liked, recognized or desired might have such a significant negative impact on performance. This might just be our cognitive biases kicking in, equating popularity with "good" when, in certain circumstances, the opposite is more likely. People like Keynes and Graham understood this well, which is probably also why they were so successful with their investments. One last word about popularity, a recent study in the U.S. revealed that kids that were "popular" at school fared surprisingly poorly as adults later on in life[5]… Go figure!

Where Do We Go From Here?

The majority of asset classes across the board have been rallying over the last couple of weeks, reflecting the ongoing economic outlook uncertainties weighing on investors, as contrasting signals create a "tug of war" condition of competing forces between greed and fear. Sentiment is also being swayed by the illusionary effects of another strong earnings season, which is more the result of substantial downward adjustments of earnings expectations by analysts than any actual real gains. These artificially created "tail winds" are also being compounded by the numerous ongoing political bluffs and blunders of the Trump administration, upending the post-war geopolitical balance and contributing to significant potential risks over the longer term.

Markets appear increasingly desensitized to Trump's repetitive "theatrics", which consist of threats, renegotiation of existing agreements and a new round of threats when that fails. The trade confrontations with China have spooked markets because of its potential of derailing the global recovery, but there are also other, potentially more serious

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[2] Robert Shiller's newly published book delves into the importance of popular narratives in determining booms and busts. https://press.princeton.edu/books/hardcover/9780691182292/narrative-economics

[3] The CAPM says that all assets are priced according to a single, systematic factor—namely, "market risk" or covariance with the capitalization-weighted market portfolio.

[4] Popularity: A Bridge between Classical and Behavioral Finance. https://www.cfainstitute.org/en/research/foundation/2018/popularity-bridge-between-classical-and-behavioral-finance

[5] What Ever Happened To The 'Cool' Kids? Long-Term Sequelae Of Early Adolescent Pseudomature Behavior https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4165811/

consequences down the road to consider. Trump's approach appears to be causing significant animosity and the potential consequences of these don't seem to be priced into the markets. Other emerging uncertainties on the horizon include the impeachment proceedings that are gaining ground as revelations of additional impeachable offenses surface. This is having a toxic effect on politics in the U.S. as we approach an election year, increasing the polarization between the two main rival parties and setting the grounds for further confrontations.

The other major conundrum facing markets is the stuck-in-a-perpetual-loopback Brexit ordeal that may nevertheless be reaching a critical "make or break" juncture, as Brexit fatigue spreads. Although the new proposed agreement with the EU is within striking distance of being approved by parliament, it is the strong political cleavages between pro Brexiters and those against that are making it impossible to reach a sufficient enough consensus to end the deadlock. This means another extension of the deadline until at least the end of January is all but guaranteed, which, although diminishing the risks of a "hard" Brexit in the near term, will not resolve the political haggling[6]. Even though it appears that the January extension will be the last one (given that this will be the third one in as many years), how all this unfolds is very uncertain at this time given that the UK is facing the prospects of elections and a referendum before the end of the year, and that event has the potential of either reinforcing or weakening the Brexit momentum dramatically.

Although the most likely outcome of all this will be a negotiated settlement before the end of January, it doesn't preclude a hard Brexit from materializing given that the deadline, unlike previous ones, will be firm. Other risks on the horizon appear geopolitical in nature, spanning from China's internal frictions as it continues to grapple with the Hong Kong protests and growing social discontent from a weakening economy, to the new conflict dynamics that are emerging in the Middle East. As Russia, Turkey and Iran consolidate their recent victories in the region at the expense of the U.S., and as the Trump administration continues to proceed with its global disengagement doctrine, the new world order that is beginning to take shape is one fraught with dangers which will invariably have a negative spillover effect on the global economy.

One last thing: October marks the 90th anniversary of the start of the great depression, a decade of economic misery and unparalleled stock market losses ensued. Although much has changed since then and the economies and markets are very different today, it is also telling to note that stock multiples right before the stock market crash happened were at reasonable levels just as they appear to be currently. It goes to say that the real dangers may be lurking elsewhere, and just like with any black swan event, it may be too late to do anything about it.

Altug Ulkumen, CFA

Independent Contributor
aulkumen@gmail.com

[6] The UK has more to lose economically than the EU in the event of an exit without a deal, although such an outcome is in no one's interest, given the geographical proximity and financial interdependence of the British and EU economies. The EU, on the other hand, has to tread carefully between applying the carrot with regards to the outcome. A hard "Brexit" and the financial repercussions would discourage other aspirants from following suite, whilst a deal that would be overly in favor of the UK would embolden others to follow a similar path.