PFP Wealth Management

Lion House
72-75 Red Lion Street
London, WC1R 4NA
020 7400 1863

www.pfpg.co.uk

31st March 2014

Lured by plausible nonsense

"One of the peculiar sins of the twentieth century which we've developed to a very high level is the sin of credulity. It has been said that when human beings stop believing in God they believe in nothing. The truth is much worse: they believe in anything."

- Malcolm Muggeridge.

Finding a cure for cancer always makes for a good story. So the New York Times runs it:

"Within a year, if all goes well, the first cancer patient will be injected with two new drugs that can eradicate any type of cancer, with no obvious side effects and no drug resistance.."

Cancer experts, including a Nobel Laureate, are reported to be "electrified" by the results. While existing treatments can only slow the disease, the new trials are said to eradicate tumours completely. The company that holds the licence for the treatments is mentioned as well. Its name is Entremed. The stock price responds immediately, and rises by 600%. The news is extraordinary, and extremely exciting.

It just isn't new. As Thomas Schuster points out in his study of financial markets and their relationships with mass media (you can read it here), the New York Times had itself reported the same story in an article half a year earlier. The original copy contained all the 'active ingredients' repeated in the more recent cover story: the amazing research results; the breathless enthusiasm of experts; the name of the licensee, Entremed. CNN and CNBC also happened to report the story. Economically speaking, the cover story is news without any information content: the market already knew the pertinent facts six months ago. If the efficient market hypothesis were valid, the republication of the story should have had little or no effect on Entremed's share price. But it did.

"Isn't it funny," said a senior portfolio manager once, "when you walk into an investment firm and you see all of the financial advisers watching CNBC. That gives me the same feeling of confidence I would have if I walked into the Mayo clinic or Sloan Kettering and all the medical staff were watching General Hospital."

The media structure content by selection and evaluation. But the ***weighting*** of information in the media, suggests Schuster, never corresponds to the distribution of information in reality:

"The media produce explanations by establishing logical links and causal relations; these interpretations, though, are only more or less adequate to reality. The media enrich information by adding new elements such as "emotion" or "suspense"; through this process, however, the character of the information is altered. The media can even create their own events where nothing would happen otherwise – or they can encourage others to do so. In short: the media select, they interpret, they emotionalize and they create facts."

Pity the poor journalist who must make a daily market report trying to explain price movements with (necessarily) imperfect knowledge of what really triggered them.

"A typical stock market report looks like this: Stock X increased because.. Index Y crashed due to.. Prices Z continue to rise after.. Most of these explanations are post-hoc rationalizations. Correlations which do not really exist are established. Reasons are constructed which can be interchanged arbitrarily. The explanations, as it seems, are quite obvious, even if they are far-fetched. In a nutshell: an artificial logic is created, based on a simplistic understanding of the markets, which implies that there are simple explanations for most price movements; that price movements follow rules which then lead to systematic patterns; and of course that the news disseminated by the media decisively contribute to the emergence of price movements."

Just as nature abhors a vacuum, so humanity abhors uncertainty. The tragedy of flight MH370 shows this human characteristic in spades. The families of the passengers are wholly justified in wanting to know the truth. But for the rest of us, we find it extraordinarily difficult to live with the uncertainty of a missing plane. We demand answers. And human beings are suckers for narrative. We would rather grasp onto the most fanciful theorizing than accept that some things may never be known to us. In a world of uncertainty, we crave concrete certitude. So we are inevitably setting ourselves up for disappointment; we are invariably going to be fooled, at least some of the time, lured by plausible nonsense.

Speaking of plausible nonsense, there must have been some reason for investors to have been buying shares of newly listed King Digital (makers of the online game Candy Crush) in the secondary market this week, but we're not aware of any compelling ones. Certainly not on valuation grounds. But then valuations in the US equity market as a whole seem to have got somewhat ahead of themselves. Value investor Tobias Carlisle (along with Tocqueville Funds' François Sicart, and Farnam Street Investments) points out that the distribution of price / earnings multiples within the S&P 500 index is at its tightest level for 25 years. Or to put it in plainer English, ***this is the worst value opportunity set within the US stock market for a quarter of a century.*** James Montier of GMO agrees, calling it a "hideous opportunity set" for investors..

"..a reflection of the central bank policies around the world. They drive the returns on all assets down to zero, pushing everybody out on the risk curve. So today, nothing is cheap anymore in absolute terms. There are pockets of relative attractiveness, but nothing is cheap or even at fair value. Everything is expensive. As an investor, you have to stick with the best of a bad bunch."

We're not quite as downbeat as Montier, but perhaps only because, since we manage less money than GMO, we're completely unconstrained as to benchmarks, markets and indices, and have no pressure whatever to own US stocks when they don't offer compelling value – which they don't appear to, today. Such is the curse of indexation and benchmarking – when you have to own a market irrespective of whether you like it. (This is also the curse of the asset ***gatherer*** versus the asset ***manager***.) Since we're not obligated to fish for stocks in US waters, we can take advantage of deep value opportunities in smaller and mid-cap markets throughout Asia (and notably Japan), where Ben Graham-style deep value opportunities still exist offering some semblance of a margin of safety.

The 1,000 lb gorilla in the room remains the Fed. Can the US central bank really end QE without material consequences across asset markets ? Place your bets. There is not much evidence of the 'worry gene' prevalent in financial media, which have a vested interest in delivering positive, reassuring news. Robert Shiller in his celebrated 'Irrational Exuberance' noted that

"Many news stories.. seem to have been written under a deadline to produce something – *anything* – to go along with the numbers from the market.. Sometimes the article is so completely devoid of genuine thought about the reasons for the bull market and the context for considering its outlook that it is hard to believe that the writer was other than cynical in his or her approach."

If it's any consolation (either to Shiller or to ourselves), those market updates are increasingly being written by machines. Stupid or cynical they are not, unless programmed to be so. But trustworthy ?

Tim Price
Director of Investment
PFP Wealth Management
31st March 2014.

Follow me on twitter: timfprice