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CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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ASSET MANAGEMENT

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7 Behavioural biases to avoid when investing

It is not unusual for investors to sense a tug-of-war between their analytical brains and their emotions.

Investing was previously considered to be purely logical, once you found the right strategy or model, you would invest. But any investor, who at the first sign of a market down turn, has sold their portfolio has acted on emotions. Often, this emotional response is due to a behavioural bias. Perhaps the investor just wanted to feel in control, so even an emotional decision to sell seems better than just sitting back and doing nothing.

Even after working with their financial advisor to determine their risk tolerance and objectives, investors still react in the moment or have trouble shedding long-held beliefs that may hurt their investment returns.

Cognitive and behavioural researchers have found many common biases that affect investing. Here are seven biases that may affect investing performance:

LOSS AVERSION

Clients often feel the pain of loss more than the joy of gains. Loss aversion takes hold when a client recalls their portfolio losses more vividly than the gains, even if the gains were greater. It upsets investors to lose money when the market goes down, and they tend to remember losses forever, but they do not remember the years when they made superior gains.

CONFIRMATION BIAS

Clients are often drawn to information or ideas that confirm existing beliefs and opinions. For example, TV viewers may prefer a news channel that represents their own political views, while avoiding those featuring commentators with different opinions.

This may often be the same when it comes to investing. An investor may have a belief about market conditions and gravitate toward information sources that confirm that belief.

Confirmation bias happens when we attach an emphasis to the outcomes we want. A way to overcome this bias is for clients to consider information from multiple sources.

MENTAL ACCOUNTING

Mental accounting occurs when client's view the various sources of their money as being different from others.

Mental accounting can manifest itself in a few ways. The income that is earned through work may be viewed very differently to money that has been inherited, this could then affect the way the money is spent or invested. Mental accounting shows up in investor portfolios too when clients get emotionally tied to certain shares, especially if it is something they inherited or were given as a gift.

ILLUSION OF CONTROL BIAS

After the news of a plane crash, it is not difficult to find friends or family proclaiming a preference for travel by car, saying they feel more in control when driving. Many are resolute in this preference despite decades of research showing that air travel is statistically safer.

Some clients apply a similar thought process when making investment decisions. The illusion of control begins with the word 'should', 'I should be able to pick the right stocks,' or 'someone should have the ability to time the market accurately.

Clients can often justify this idea, but this thought process is damaging as they may have trouble coming to terms with the irrationality and variability of the markets performance and the impossibility of their expectation. The outcome may lead to a financial disaster and the rationalisation that while their belief is correct, the asset manager or financial advisor was not competent.

RECENCY BIAS

Consumers believe what has happened recently will continue to happen in perpetuity.

This phenomenon also exists when investing. Clients tend to chase investment performance, often investing into an asset class just as it is peaking. Because the investment has been climbing higher recently, investors believe that this will continue.

Research has shown that it is almost impossible to predict which asset class, sector or geographic region will be the top performer in any given year, however we know that past performance can be a strong driver of inflows, as few people want to feel left behind.

HINDSIGHT BIAS

"I knew that would happen."

As humans, we tend to overestimate the accuracy of our predictions, which can be very costly as we get a false sense of security when making investment decisions. This may lead to excessive risk-taking which could place our portfolios at risk. Hindsight bias can have a detrimental effect on portfolio performance.

HERD MENTALITY

This type of thought process takes hold when a person does not want to be left out of a trend.

Which is also true when it comes to investing. Just because the herd is moving into or out of a share, sector or region, it does not mean that this is the right move for each investor with their own risk profile and investment objectives. It is important to stop and ask yourself why you are making this financial decision, and looking to see if it aligns with your financial plan. Doing so will go a long way in helping ensure that the actions you are taking are right for you, not for someone else.

As asset managers, we take the behavioural components of investing seriously, and with good reason. Investors should become aware of their own biases, while not inherently bad, and most are natural to human behaviour, these biases could negatively affect their investment returns.

Cadiz recommends that investors have regular discussions with their financial advisors about market expectations and managing their emotions during all market conditions.

Shoprite – Quality on Sale

In the short-term, share prices can often become disconnected from what a business is worth as investors over react to recent news or market events. This gives an astute investor the opportunity to take advantage, and buy quality businesses at attractive prices that are likely to compound returns overtime.

SHOPRITE'S COMPETITIVE ADVANTAGES MAKE IT A QUALITY BUSINESS

Shoprite can be described as a high-quality business, with a history of consistently earning a return on capital greater than its cost of capital, thereby creating economic value for shareholders that compounds overtime. Shoprite's competitive advantages are their economies of scale, a more efficient supply chain and they have built up a first mover advantage in Africa.

- Economies of scale advantage

  Because of Shoprite's extensive store footprint throughout South Africa, and the large volume of goods that goes through these stores, Shoprite has been able to source goods cheaper than its competitors. Some of these cost savings can be passed onto its customers by charging lower prices. This generates increased loyalty and demand, leading to further scale advantages. Greater scale also allows the Group to spread its fixed costs over a larger number of products, effectively reducing the overall 'cost per unit'. The lower prices that Shoprite can offer customers helps prevent new entrants into the sector, as they struggle to compete.

- Supply chain advantage

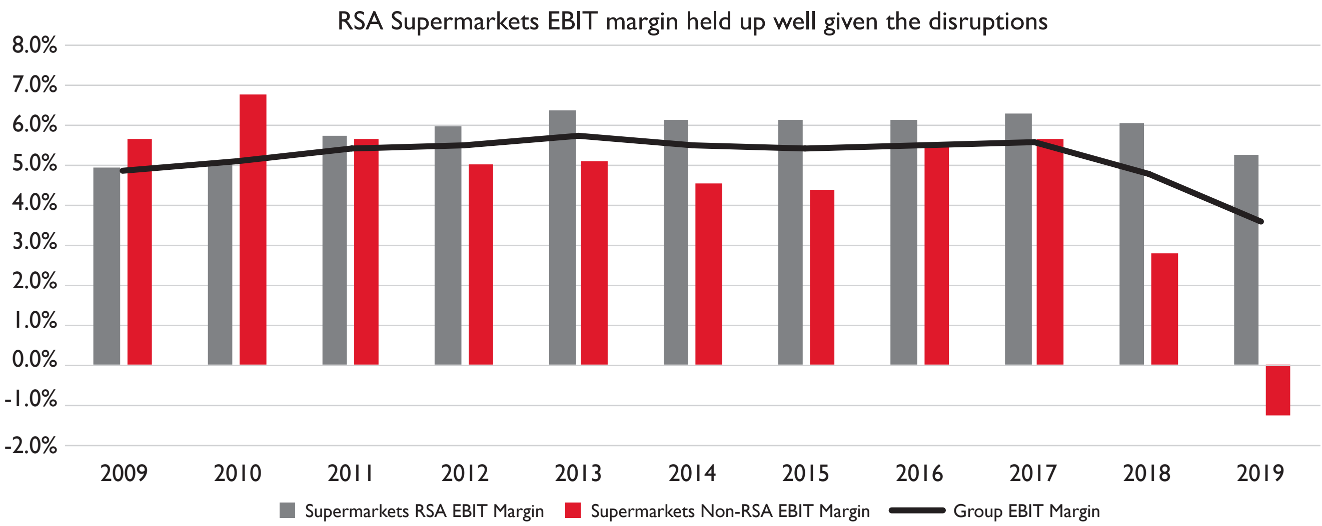
  Shoprite was the first of the food retailers to set up distribution centres (DC's) and centralise their supply chain. The centralised supply chain has resulted in reduced transport costs for suppliers, while ensuring the quality of the product. The Group's fleet of trucks are used more efficiently to transport goods along optimised routes to the stores. This results in an improvement in the lead time of products to stores, and on-shelf availability. The DC's also enable better space utilisation within the Group's individual stores. The efficient use of space results in cost savings, and increased sales.

- First mover advantage in Africa

  Shoprite have been expanding in Africa for 20 odd years and the Group has 424 stores in 14 countries, with Angola and Nigeria being their largest operations. This early investment has been capital intensive and tough to execute at times. They have had to deal with varying regulatory requirements, poor infrastructure, and have had to, in certain instances, build the malls or shops for their stores. In order to get the goods to market, Shoprite have also had to establish an effective supply chain and transportation network. This has created a barrier to entry as new entrants are discouraged from competing due to the large amounts of capital, time and understanding of operating in Africa, that are needed.

SHOPRITE'S FINANCIAL YEAR 2019 RESULTS DISAPPOINTED THE MARKET BUT ARE TEMPORARY

Shoprite's trading margin for South Africa was down but not a disaster, while the African operations made losses which caused Group earnings to deteriorate in 2019, as shown in the chart below. We believe this is temporary and expect the trading margins to improve over the coming years.



Source: Shoprite Annual Reports, Cadiz Asset Management

- **The South African operations** (~80% of Group revenue) were affected by a six-week service provider strike at their largest DC in Gauteng, in the first half of the year. At the same time, Shoprite had issues implementing their new IT system, which impacted the Group's ability to meet store demand. This resulted in the Group losing market share.

  Despite these issues, the South African Supermarkets division still managed to generate a 5.3% operating margin for the full year (which is about double that of competitor Pick n Pay). Shoprite has recently released an operations update stating that their local supermarket sales have increased by 10.3% in the first quarter of FY2020, indicating that they are well on their way to regaining lost market share.

- **The Rest of Africa division**, which makes up ~15% of the Group revenue, had a negative trading margin. This surprised the market. This was largely impacted by significant currency devaluation, import impediments and customer affordability. Management have stated that the division will most likely be loss making in FY 2020 as some of these headwinds persist.

  In the long-term however, we believe management will be able to return this division to profitability and position Shoprite to benefit from the high growth rates expected in Africa. The high barriers to entry will ensure Shoprite retains its competitive advantage in those markets.

We believe the market over reacted to Shoprite's poor FY 2019 results causing the share price to fall from R160 to R110 per share. This gave us an opportunity to buy a quality business at a significantly discounted price. Overtime we expect this investment in Shoprite will add significant returns for our clients.