

CUHK Workshop 1: Behavioral Finance & Value Investing

February 2025



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Introduction

- **Investing is a Relative Zero-Sum Game, and After Fees Most Funds Underperform**
- **Value Investing is “Investing” not “Speculating” = Intrinsic Value Driven, Long-Term**
 - Are there many investors in the market, or is everyone a speculator? Who has an indefinite holding period?
- **Why Does the Opportunity Exist?**
- **Can Understanding Biases Help Us Become Better Investors?**



Introduction

- **Price is Determined by the Marginal Buyer and Seller of the Security**
- **Who is the Marginal Buyer and Seller of a Security? What Edge Do You Have Over Them?**
 - Informational, Analytical, Time Horizon, and Sentiment
 - Types of Participants (Hedge Funds, Long Only, Quant, Retail, Passive)
- **Stochastic Not Deterministic, Understand Edge is a Source of Safety**
 - Significant Variance in Distribution of Long-Term Returns
 - Understanding Biases Avoids Being the Patsy



Capitalism & Its Brutality

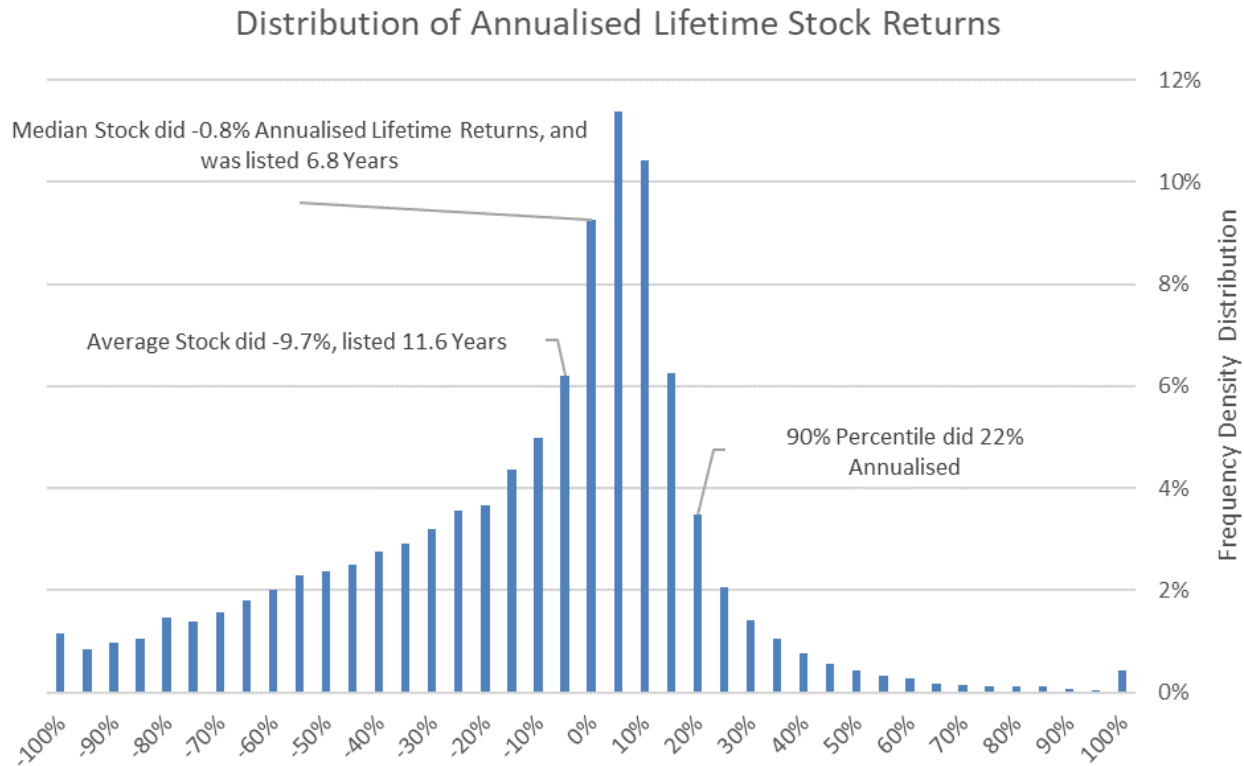
- **Capitalism is Brutal, Schumpeter's (1942) Creative Destruction!**
 - Only 86 stocks (0.33% of stocks) account for over half the US market wealth creation from 1926 to 2016, and 4% account for all stock market-gains above treasury bills.
 - Only c.43% of stocks exceeded treasuries. (Bessembinder, 2018)
 - 36% of stocks faced >80% lifetime cumulative declines (total-return)
- **Over 10-year period 39% of stocks had negative absolute returns, and 58% underperformed the market (Klement; 2020)**



Underappreciation of Compounding

- **Most Investors and Individuals Underappreciate Compounding**

- Which stock do you think had the best cumulative lifetime returns in the US (1926 to 2024)?



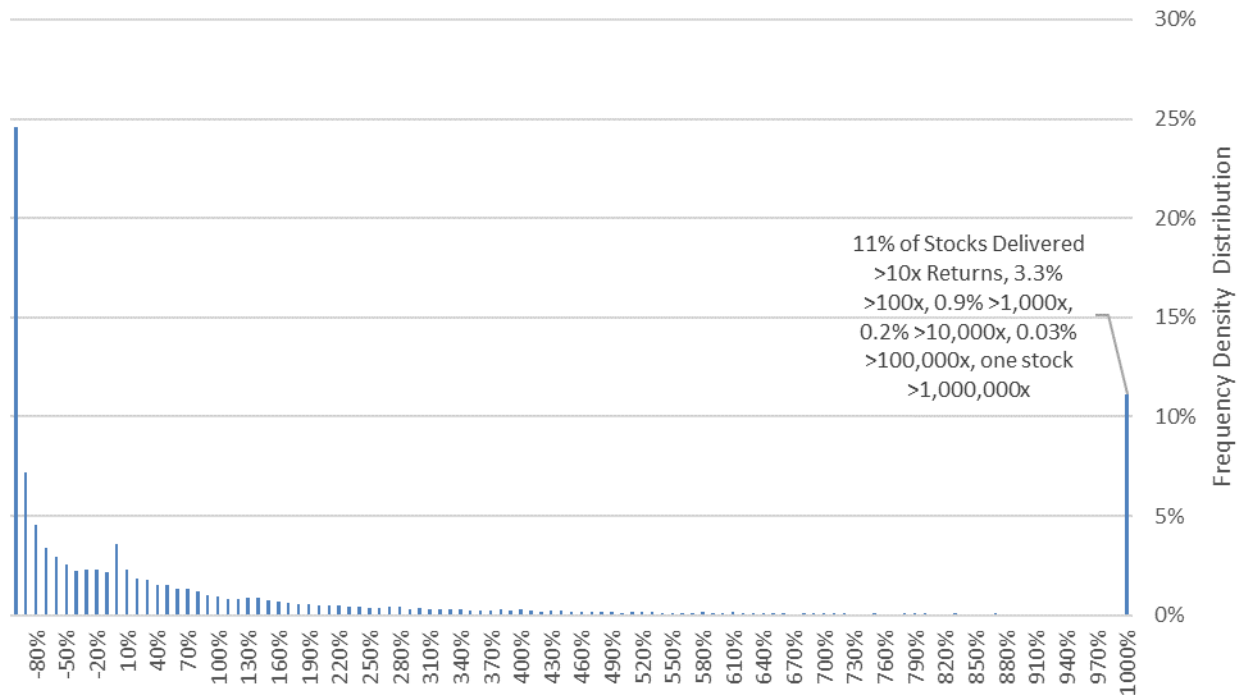
Underappreciation of Compounding

- **Compounding Has a Significant Impact on the Distribution!**

- Is it smart to interrupt the compounding of your winners? Coffee can approach?



Distribution of Cumulative Lifetime Stock Returns



Excessive Information & Shortening Attention Spans

- The World Is Short Patience and Long Instant Gratification
- Meme Stocks, Crypto, Get Rich Quick



Source: WFE, IMF. *NYSE and NASDAQ market capitalisation divided by total turnover value



Behavioral Finance

- **Daniel Kahneman Won the Nobel Prize (2002), Due to Behavioral Finance**
- **People Aren't Rational Utility Maximisers, Heuristics and Biases are at Large**
- **Anchoring, Confirmation, Recency, Herding, Ambiguity Aversion, Myopic Loss Aversion**
 - Do these systematic biases explain why discrepancies to fair-value may exist?
 - Can understanding our biases help us avoid eroding our edge?



Incentives & Loss Aversion

- **Just Like Pavlov's Dog: Incentives, Feedback Loops, and Conditioning**
 - Long-Termism is a Key Edge (Clients, Information, Politics, Gratification)
 - Loss Aversion: Losses Hurt More Than Gains Bring Happiness
 - Loss Aversion, Social Proof, Recency Bias all Intertwine with Incentives
 - Lollapalooza as Munger would say!



Herding, Confirmation

- **Herding Bias: Consensus Thinking, Swings in Market Sentiment**
 - Solution: No Friends, Avoid Sell-Side, Find Own Niche Herd
- **Confirmation Bias + Ambiguity Aversion: Premature and Lasting Conclusions**
 - Solution: Reject Null Hypotheses Not Confirm Them
 - Solution: Control Source of Information, Start with Objective Truths



Recency (Availability), Anchoring

- **Recency Bias: Over Emphasize Recent Events**
 - Solution: Look at long-term historical data, and seek information that leans against recent events
- **Anchoring Bias: Focus on Arbitrary Reference Points, Slow to Adjust**
 - Solution: Avoid Consensus, Use Base-Rates (Long-Term History), Adopt Scenario Analysis & Think Through Logically



Behavioral Finance – Munger’s Speech

Munger's Psychological Tendencies	Behaviorial Bias	Academic Coined	Market Issues & Implications
1. Reward and Punishment Superresponse	Incentive-Caused Bias	Jensen (2000)	Principle-Agency Issues (Beta-Loving - Fees, Career Asymmetry, Consensus Thinking - Internal Politics), Short-Termism
2. Liking/Loving	Affinity/Familiarity Bias	Huberman (2001)	Loved & Simple Businesses, Charismatic CEOs, Home Bias, LT Winners
3. Disliking/Hating	Negativity Bias	Rozin; Royzman (2001)	Overreact Negative News, Avoid Hates Sectors (Tobacco, Coal, Vices)
4. Doubt-Avoidance	Ambiguity Aversion	Ellsberg (1961)	Underappreciate Uncertainty (Stochastic not Deterministics), Sentiment Driven, Recency Bias
5. Inconsistency-Avoidance	Status Quo Bias	Samuelson; Zeckhauser (1988)	LT Momentum, Inability to Update Thoughts with Evidence
6. Curiosity			Excessive Trading
7. Kantian Fairness	Fairness Bias	Kahneman et al. (1986)	Slow to Adopt New Trends (Feels Unfair)
8. Envy/Jealousy	Relative Deprivation Bias	Festinger (1954)	Consensus, Leverage, Difficulty in Underperforming
9. Reciprocation	Reciprocity Bias	Cialdini (2001)	Favour Broker & Network Sourced Ideas
10. Influence-from-Mere-Association	Halo Effect	Thorndike (1920)	Bias Towardsw Visionary CEOs, Familiarity Loved Brands
11. Pain-Avoiding Denial	Loss Aversion	Kahneman; Tversky (1979)	Holding Losers, Prematurely Selling Winners
12. Excessive Self-Regard	Overconfidence Bias	Barber; Odean (2001)	Excessive Concentration & Trading
13. Overoptimism	Optimism Bias	Weinstein (1980)	Overvaluation of Highly Uncertain Stocks (Risk-Loving; Beta Paradox)
14. Deprival-Superreaction	Endowment Effect	Thaler (1980)	Prefer Existing Positions to New Ideas
15. Social Proof	Herding Behavior	Banerjee (1992)	Consensus, Sell-Side Reliance, Bubbles
16. Contrast-Misreaction	Anchoring Bias	Tversky; Kahneman (1974)	Slowness to Adjust to Cycles (Fundamentals, Sentiment), Valuation Anchoring
17. Stress-Influence	Emotional Bias	Loewenstein et al. (2001)	Overreaction to Bad News, Regret Aversion (FOMO Trades)
18. Availability-Misweighing	Availability Heuristic (Recency Bias)	Tversky; Kahneman (1973)	Over-emphasis Recent News, Consensus (Frequent Views), and Trends
19. Use-It-or-Lose-It	Skill Decay Bias		
20. Drug-Misinfluence	Impulsivity Bias		Over-Acting
21. Senescence-Misinfluence	Cognitive Decline Bias	Park et al. (2002)	
22. Authority-Misinfluence	Authority Bias	Milgram (1963)	Over Confidence from "Experts" (Insiders, Specialists, Famed Investors - Valeant?)
23. Twaddle	Noise Trading Bias	Black (1986)	
24. Reason-Respecting	Narrative Fallacy	Taleb (2007)	Herd Behaviour, Simplistic Narratives
25. Lollapalooza			Amplified Interactions (Market Sell-Offs, Periods of Stress)

CUHK Workshop 1: Searching for Ideas

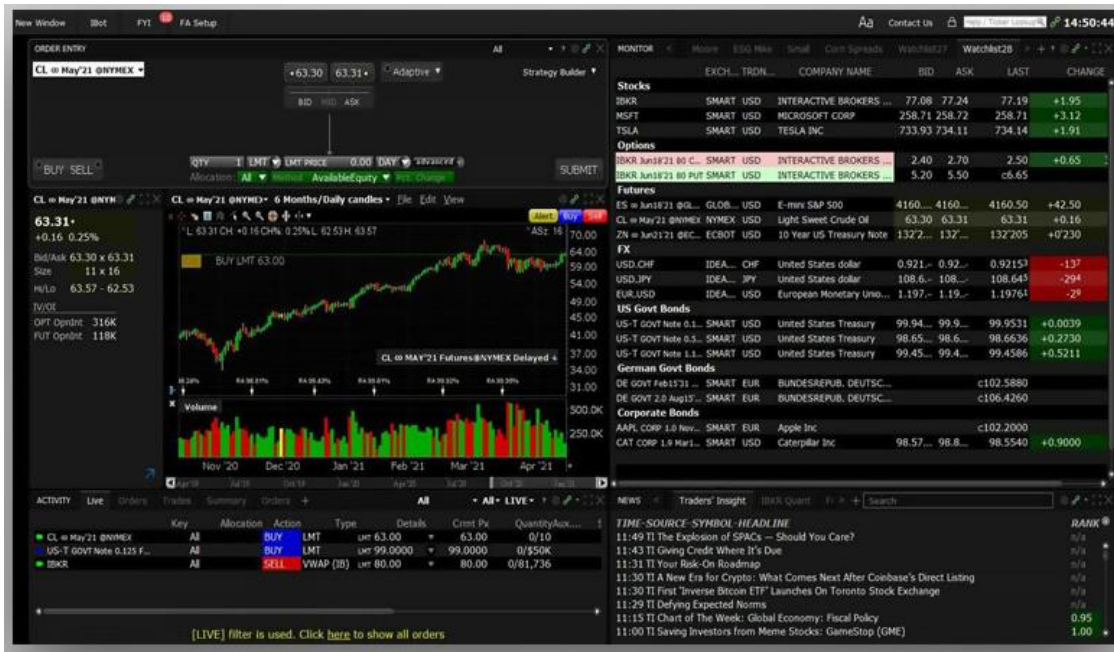
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Investing in Stocks

- What Comes to Your Mind?



Stock Market vs Shopping Mall

- **Shopping**

- Spend Some Money and Get Something Back

- **When You Buy Shares, What Do You Get Back?**

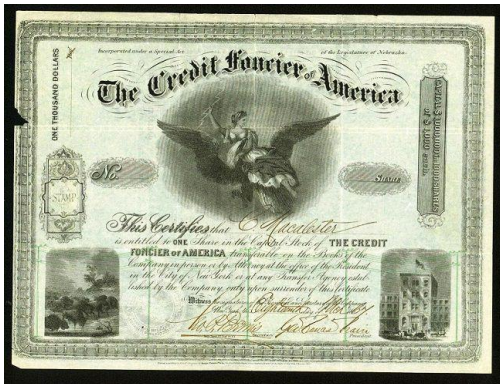
- **We Are Consumers Who Pays Money**

- What About Being the One Who Receives Money?



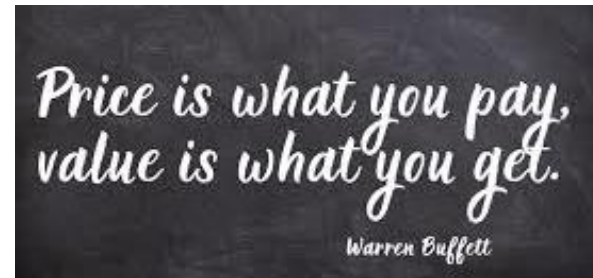
Value Investing

- Spend the Money and Get a “Number” – *Lottery (Speculation)*
- Instead, Buying Shares is Buying an Ownership to a Business
 - Allow An Ordinary Person to Be Part of the Ones “Receiving Money”
- Is Not About Short-Term Trading
 - As You Don’t Pay to Get a “Number” to Be Played Around with
- Is About Long-Term Ownership
- However, the Price You Pay Is the Cost



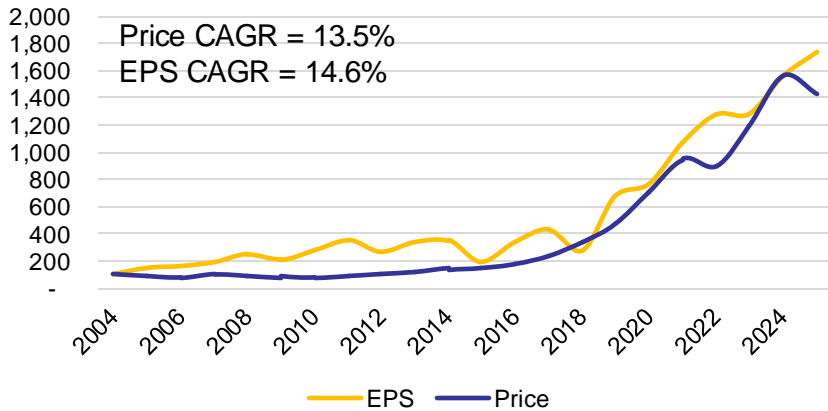
Stock Market vs Shopping Mall

- **What Would Make Your Purchase a “Good Deal”?**
 - The Product Has Very Good Quality?
 - The Price Is Very Cheap?
 - It Would Need to Be Combination of Both – *“Value-for-Money”*
- **Same Concept for Stock Investment**
 - Good Quality – Find A Superior Business
 - Pay a Reasonable or Bargain Price
- **Hold It for the Long Term**
 - Don’t Kill the Goose That Lays the Golden Eggs
 - Let the Benefit Compound

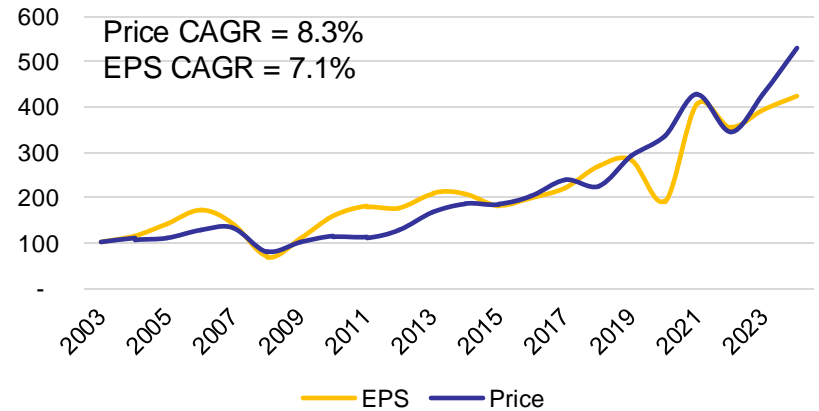


What Drives Stock Price over the LT

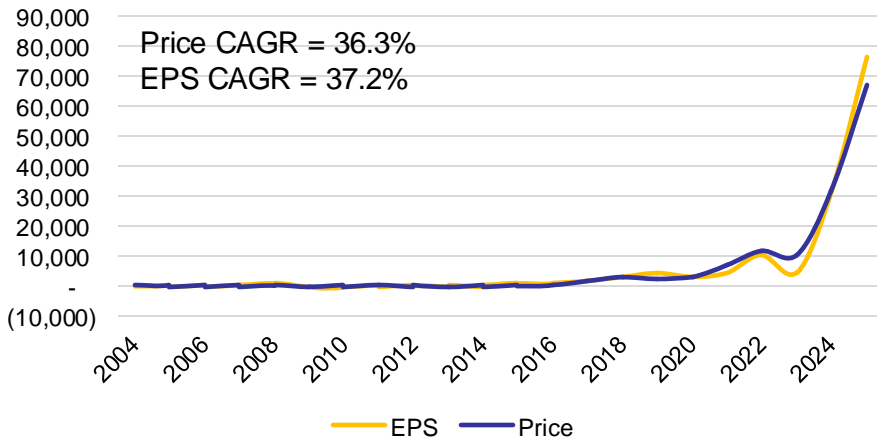
Microsoft Price vs EPS, Index to 100



S&P500 Price vs EPS, Index to 100



Nvidia Price vs EPS, Index to 100



Per Share Growth is the Key Driver of Share Price Over the Long Term

- Plus Dividend Received



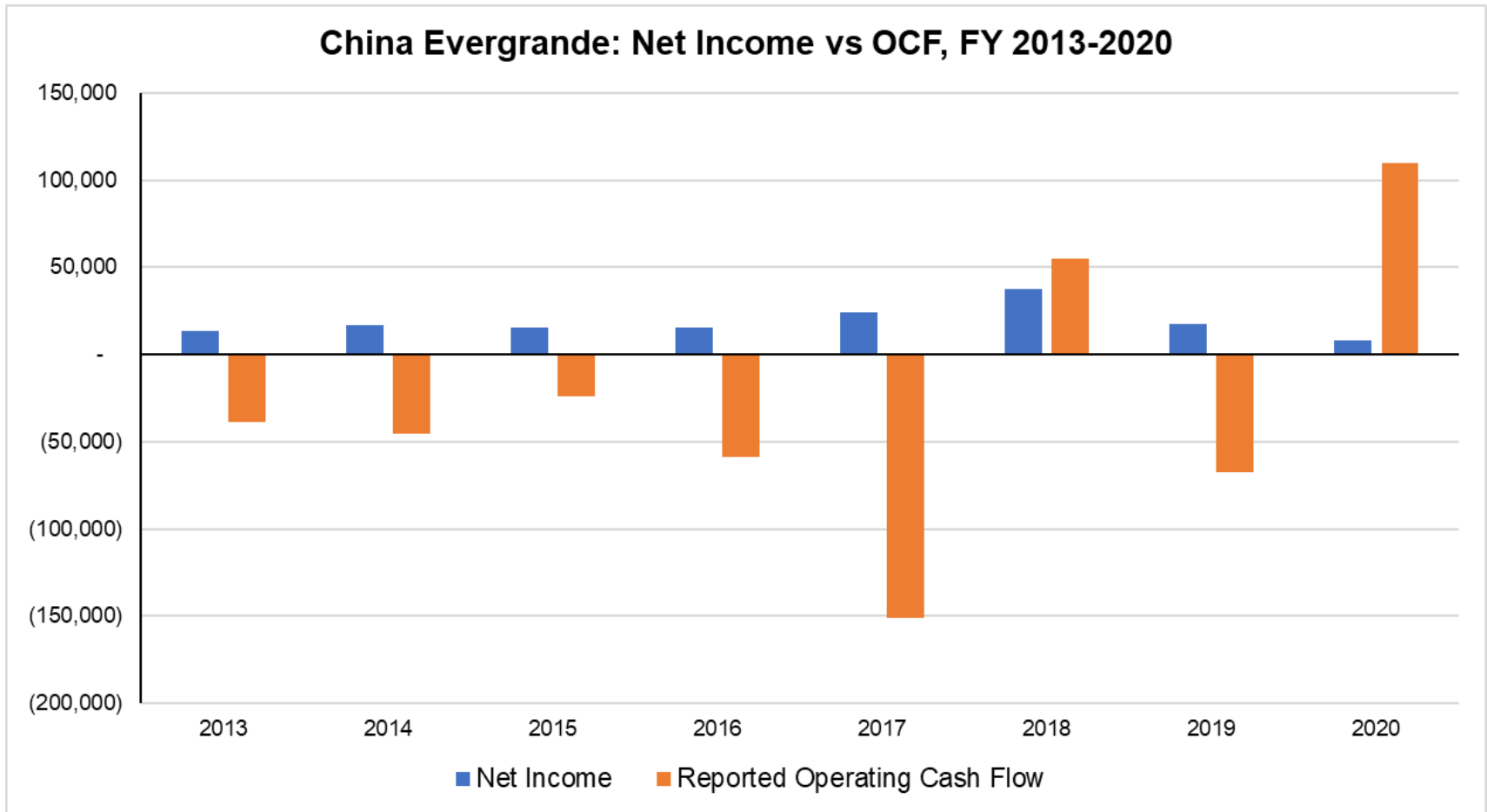
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Looking for Desired Characteristics

- **Goal: Find Businesses that Can Deliver LT Per Share Growth**
- **First and Foremost, Growth Requires Investment**
- **Assume You Are Running a Clothing Store, to Grow:**
 - Invest in Store Renovation – Capex (Capital Expenditure)
 - Purchase the Clothes in Advanced – Working Capital Investment
 - General Expenses, e.g. Salary, Marketing
- **Desired Characteristic – Consistent Generation of Free Cash Flow**
 - More Important to Focus On Cash Flow than Accounting Profits



Example: China Evergrande



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For Reference

- **Some Definitions of Cash Flows**

- Reported Cash Flow from Operation
- Free Cash Flow to Firm (FCFF) & Free Cash Flow to Equity (FCFE)
- Owner Earnings
 - $NI + DA \pm \text{Non-Cash Items} \pm \text{Chg in WC} - \text{Maintenance Capex}$
 - Maintenance Capex Need to Be Estimated Subjectively; Depreciation Might Be Used As a Crude Approximate

- **Measuring “Consistent Generation”**

- Cash Flow Conversion Ratio: $\text{Cash Flow} / \text{Net Income}$
- Cash Flow Margin: $\text{Cash Flow} / \text{Revenue}$
- Cash Flow Growth



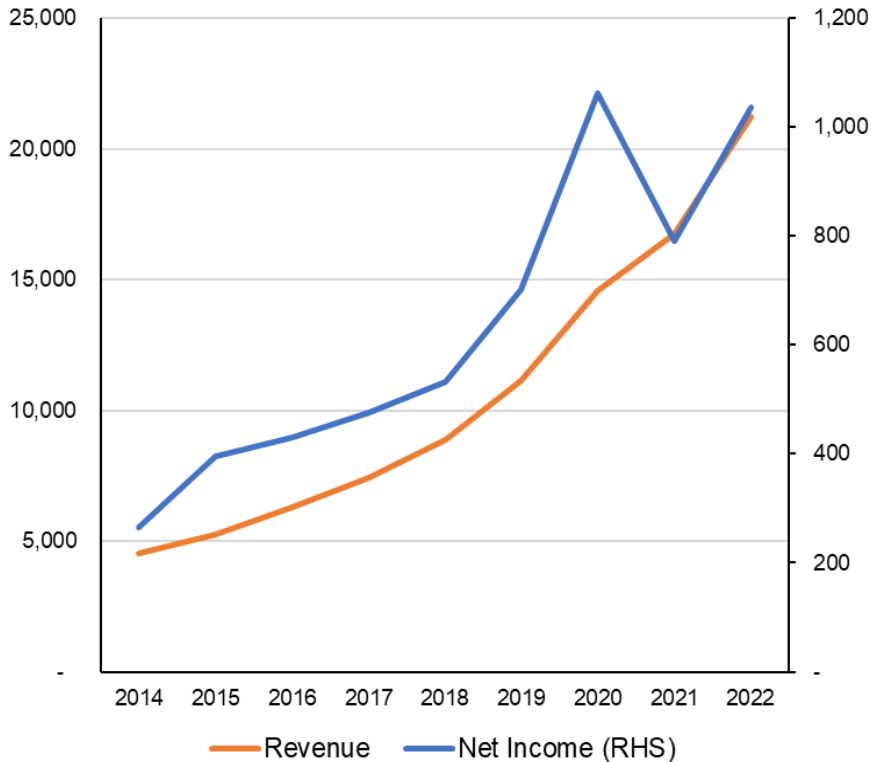
Positive Cash Generation is Not Enough

- **Need to Generate High Enough Cash to Fund the Growth**
- **External Financings Needed If Cash Generated Is Less Than Cash Required**
 - As a Result, Existing Shareholders Will Be Diluted
- **Two Major Types of External Financing:**
 - Debt Issuance => Profit Shared with Creditors
 - New Share Issuance => Direct Dilution
- **Desired Characteristic – Self-Financed Growth**

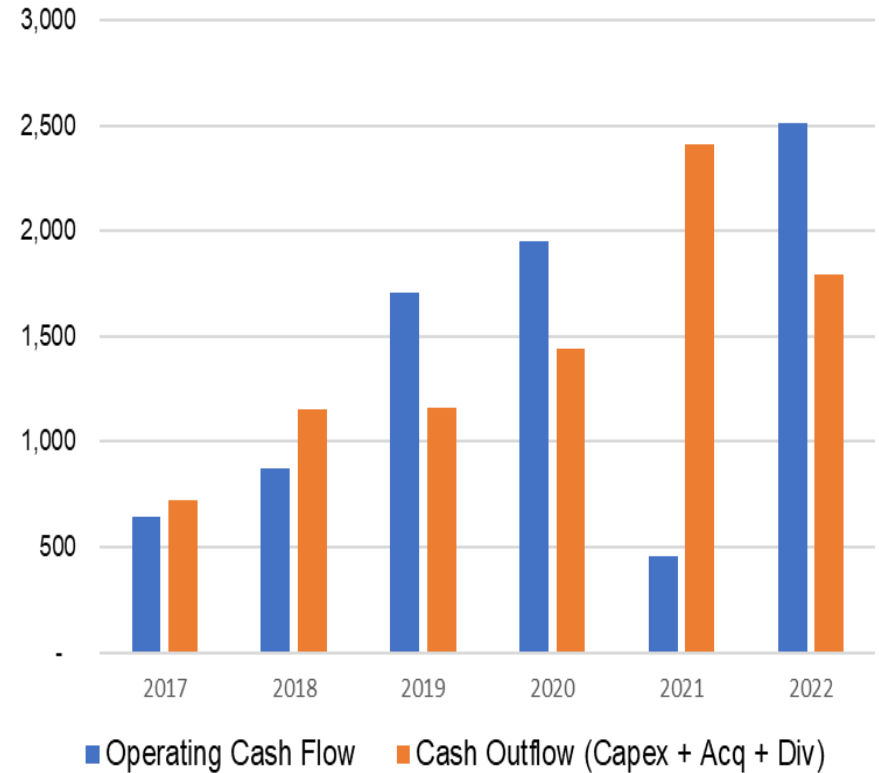


Example: Dashenlin Pharmacy

Dashenlin: Revenue & Net Income, FY 2014-2022

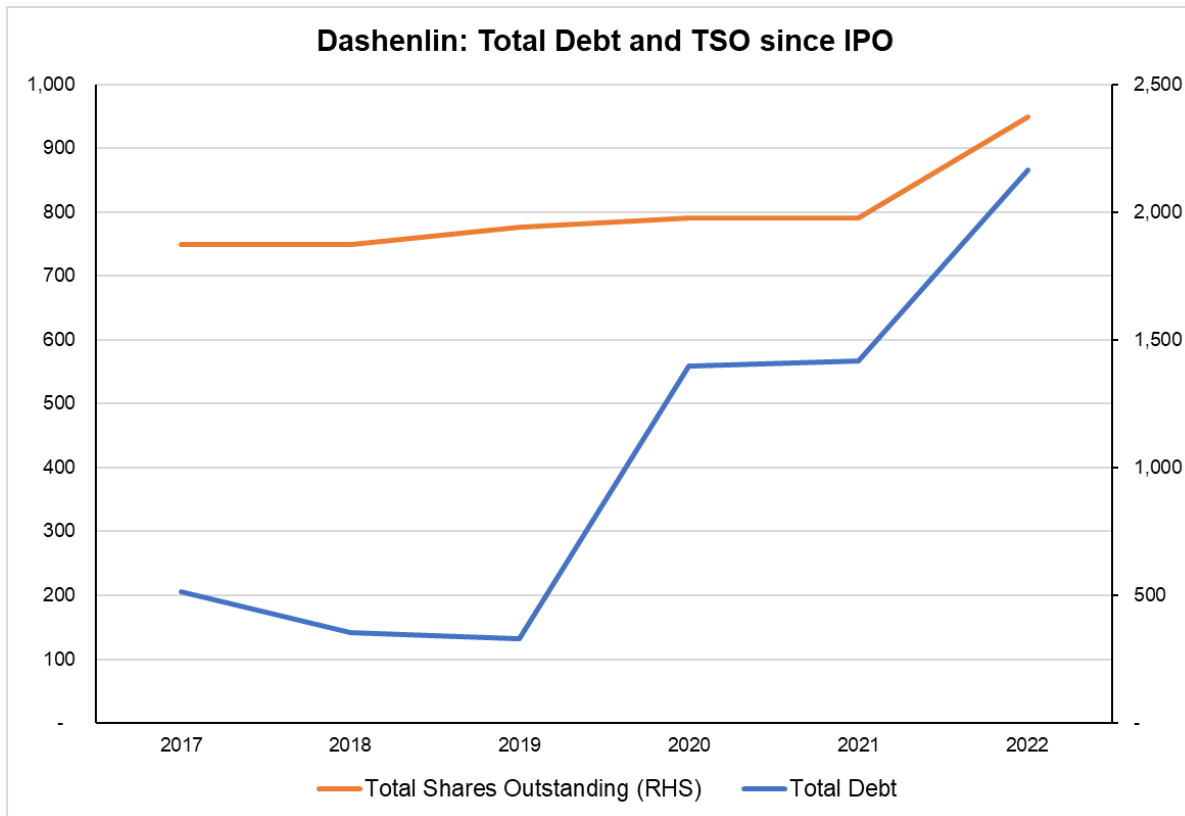


Dashenlin: OCF and Cash Outflow



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Example: Dashenlin Pharmacy



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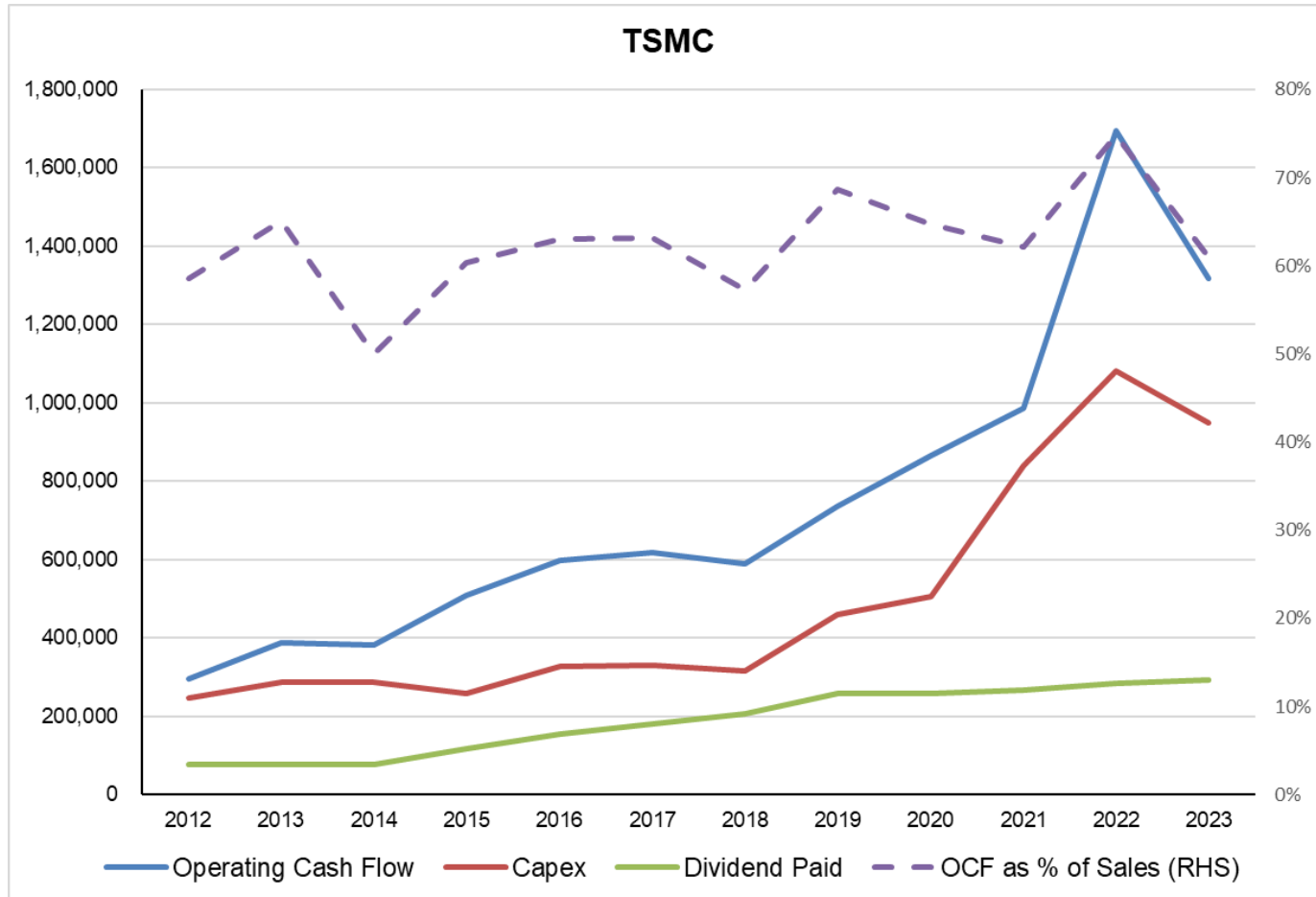
For Reference

- **Some Favorable Traits to Look For**

- High Cash Flow Generation
 - As Mentioned in “Consistent Generation of Free Cash Flow”
- Negative/Low Working Capital
 - $\text{Net Working Capital} = \text{Account Receivable} + \text{Inventory} - \text{Account Payable}$
 - $\text{Net Working Capital Days} = \text{AR Days} + \text{Inv Days} - \text{AP Days}$
- Low Capex Intensity
 - Capex as % of Sales



Example of Self-Financed Growth: TSMC




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Business Returns

- **We Want a Virtuous Cycle: Investment => Return, Return => Support Future Growth**
- **Two Important Measures of Return**
 - Return on Equity (ROE)
 - Return on Invested Capital (ROIC)
- **Desired Characteristic— High Rates of Business Returns**
- **Further Breakdown of the Returns Provides More Insights**
 - ROE: DuPont Model
 - ROIC Tree



The DuPont Model

$$ROE = \frac{\text{Net Income}}{\text{Avg Equity}} = \frac{\text{Net Income}}{\text{Revenue}} * \frac{\text{Revenue}}{\text{Avg Assets}} * \frac{\text{Avg Assets}}{\text{Avg Equity}}$$


Margin Turn-over Financial Leverage

• Three Major Sources of High Returns

- High Margin: Purchase the Cloth for \$100, Sell it for \$1000
- High Efficiency (Asset Turnover): High Daily Sales per Store
- High Leverage: Generally, NOT a Reflection of Superior Business

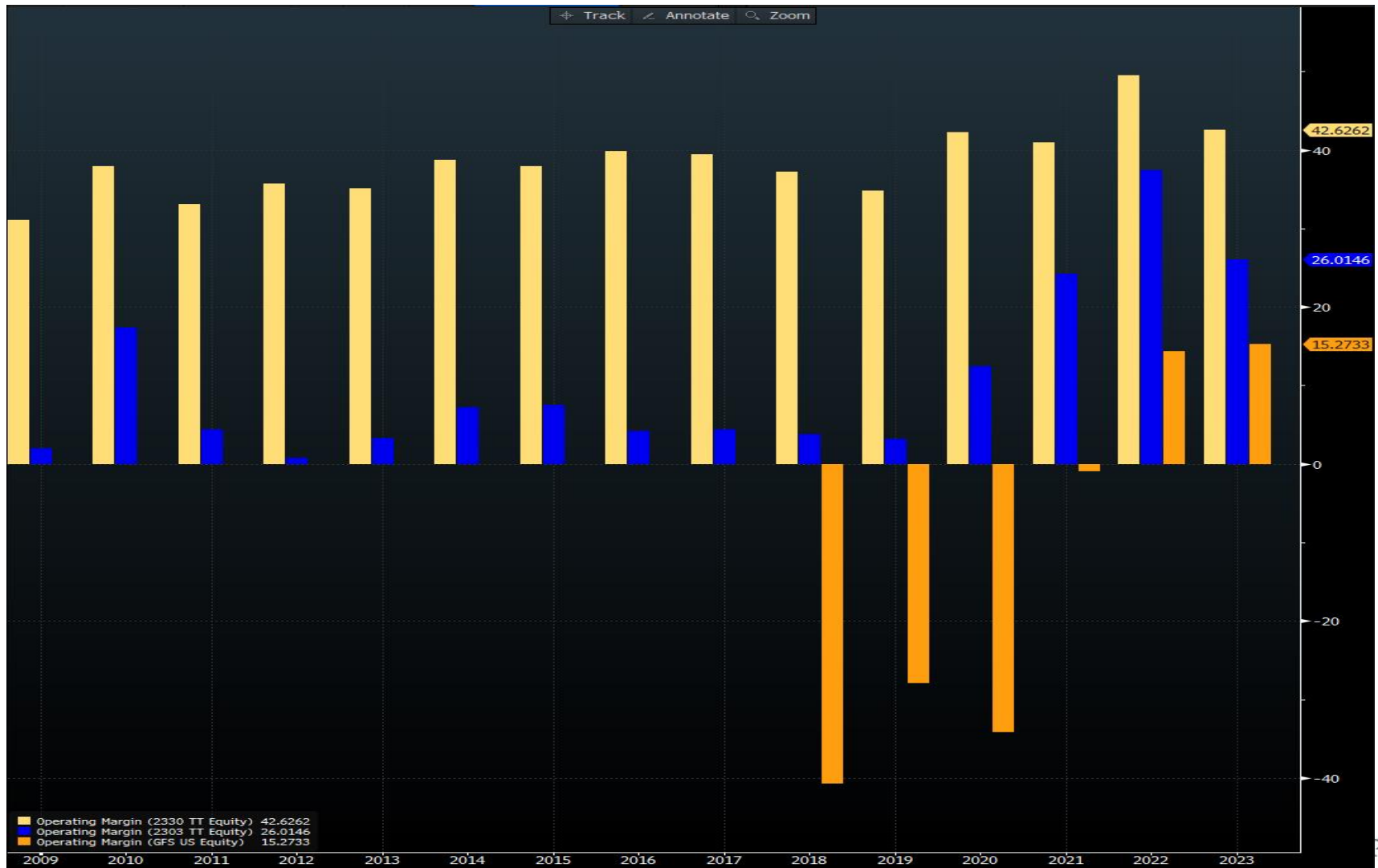


Understand the “Moat” Behind

- **High Returns Attract Competition**
 - If You Sell the \$100 Cloth for \$1000, Your Neighbor Will Likely Sell It for \$800
- **Superior Businesses Are Able to Defend the High Return with Their Moats**
 - E.g., Brand Power for Clothing Store
- **Critical to Understand the Moat, and How They Would Evolve in the Long Term**
 - Dupont Model Provides the Guide
- **Desired Characteristic – Strong Moat Usually Associates with Dominant Market Share**



OPM: TSMC vs UMC vs GlobalFoundries

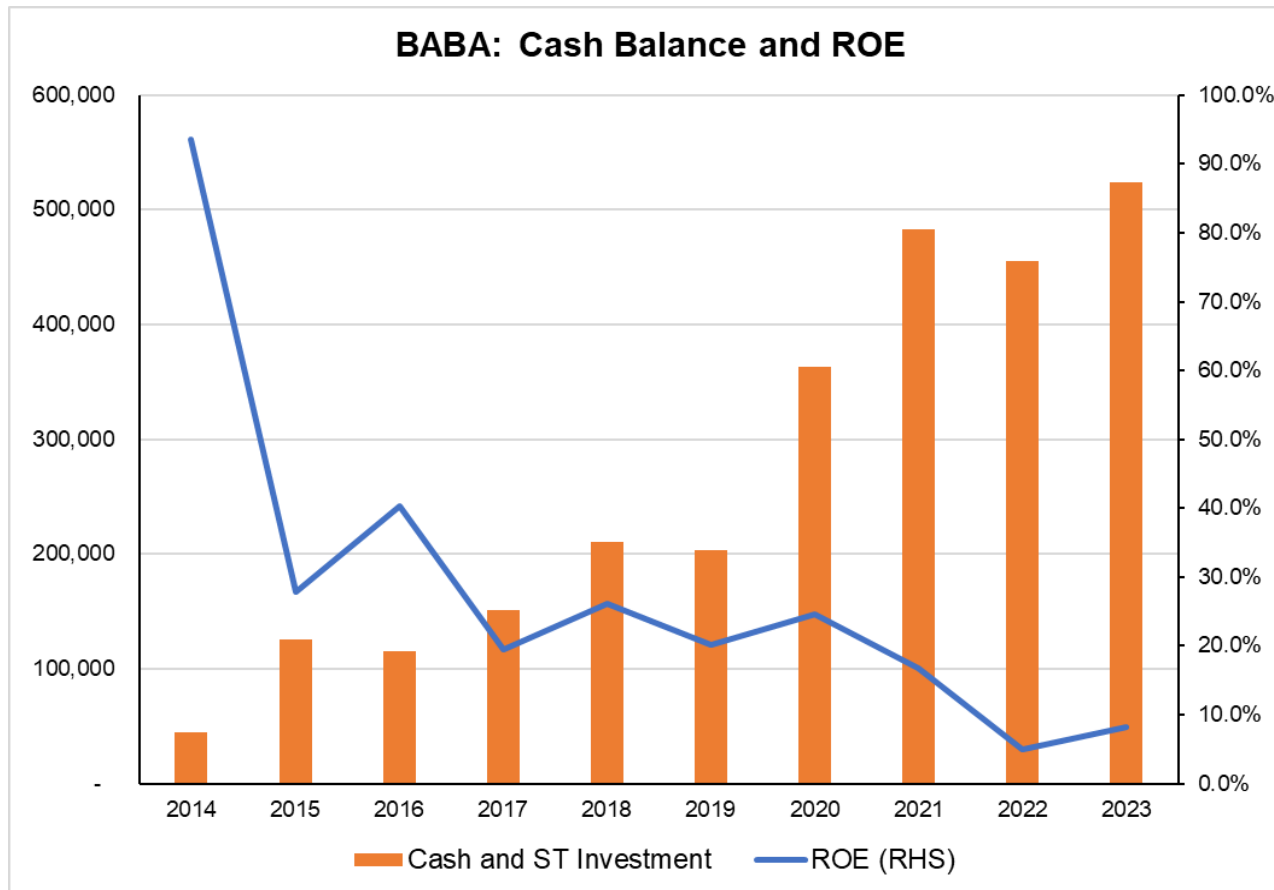


Superior Business Quality Is Not Enough

- **The Business Results Need to Be Delivered to Shareholders**
 - Superior Businesses Generate Good Cash Flows and Returns
 - But Shareholders Can Only Benefit When Those Cash Flows Are Spent Wisely
- **Management Need to Allocate the Cash Appropriately**
 - Investment Need to Generate High-Enough Returns
 - Returns Excessive Cash to Shareholders
 - Dividends and Buybacks
- **Desired Characteristic – Appropriate Capital Allocation**



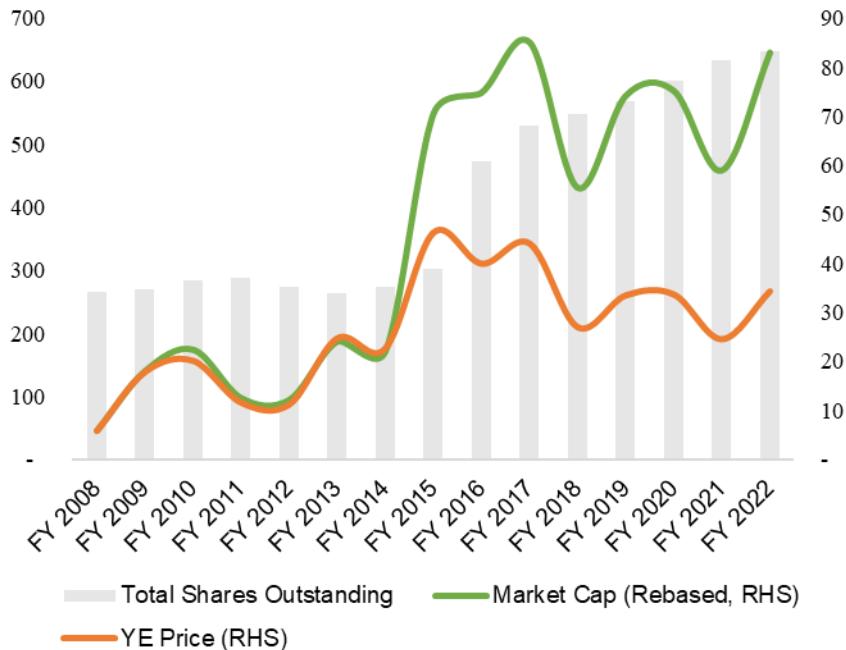
Example: Alibaba



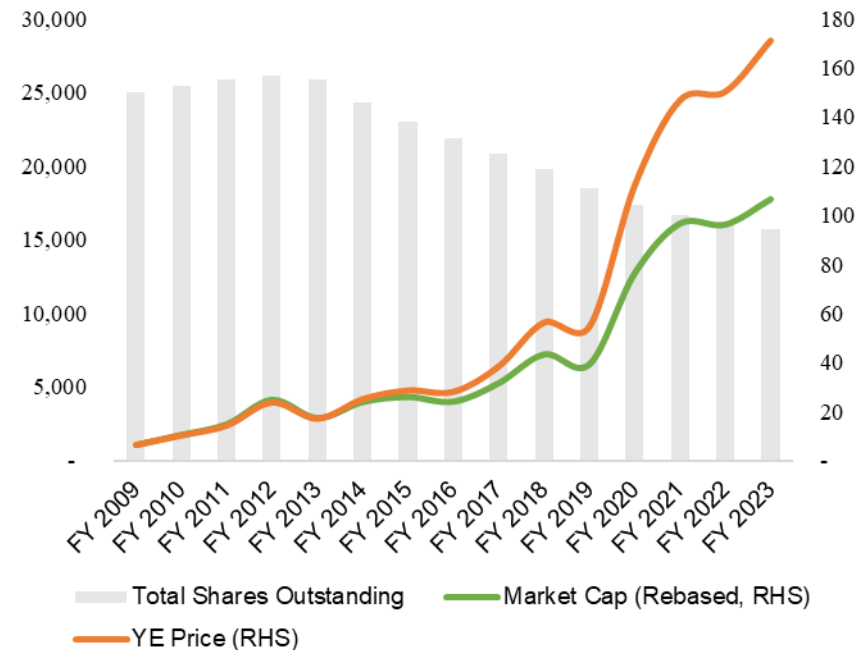
The Outcome of Superior Business

- Superior Long-Term EPS Performance
- Important to Focus on EPS Rather Than Total Earnings
 - Takes Share Dilution Into Account
 - Sources of Dilution: External Financing, ESOP

Trip.Com: YE Market Cap vs YE Price



AAPL: YE Market Cap vs YE Price

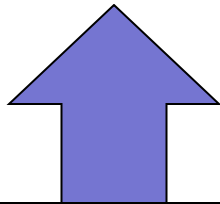


List of Desired Characteristics Discussed

- **Consistent Generation of Free Cash Flow**
- **Self-Financed Growth**
- **High Rates of Return**
 - Sustainable Moats
 - Dominant Market Share
- **Superior LT EPS Performance**
- **Appropriate Capital Allocation**
 - Returns for Shareholders



Idea Generation: Rifle vs Shotgun

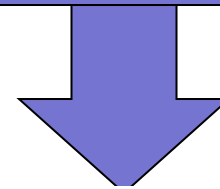


Bottoms-Up Approach

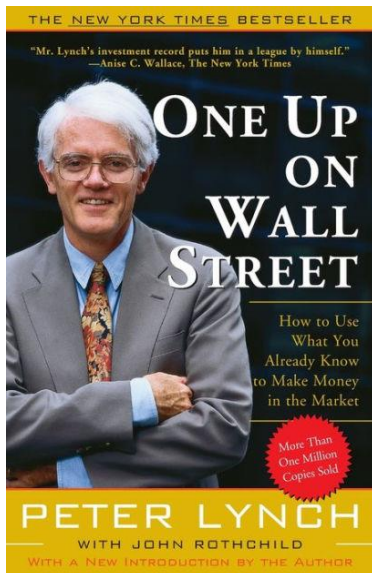
- Begin with Single Stock or Subsector in Mind
- Build up Knowledge Base & Understanding
- Go deep

Top-Down Approach

- Start with Wide Investible Universe
- Narrow Down Based on Multiple Criteria
- Can add Macro Overlay
- Output = Short list



Bottoms-Up



- “If you like the store, chances are you’ll love the stock” – *Peter Lynch*
 - Services: MSFT, Netflix, Spotify
 - Consumer Goods: AAPL, Lululemon, Nike
- Individual Investors Can Have an Edge over Professional Fund Managers
- Start with A List of Companies You Like, and Use the Characteristics as A Reference Check List
 - Great Products ≠ Great Companies ≠ Great Investments Today
 - Remember the Price and Value

Top-Down: Stock Screening

- **Pick the Desired Criteria**
- **Start From the Whole Investable Universe, Or Pick A Few Industries that You Are Familiar With**
- **Time-Series Perspective**
 - Consistency / Stability, e.g., Std Dev of 5-Yr Margins
 - Improvement / Growth, e.g., 5-Yr EPS CAGR
- **Cross-Sectional Perspective**
 - Across the Investable Universe, e.g., top 10% OPM
 - Industry Neutral, e.g., Top 20 Companies with Highest OPM from Each Industry





Thank You



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