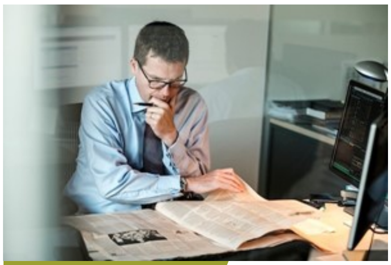

Friday Morning Coffee

European Capital Partners

Nr. 131 — "When long term investors increase their position weights"

In their widely acclaimed and celebrated masterpiece "Thinking, Fast and Slow" Nobel laureate Daniel Kahneman and his collaborator Amos Tversky represented a beautiful summation of a lifetime research and wisdom in the field of human psychology that changed the way humans, including psychologists, think about thinking and challenged some strongly held beliefs. It was revolutionary, not only because of the ideas presented in the book but also due to the way the authors have amalgamated existing research together. Human psychology is not a new field of research, in fact throughout history enormously useful cognitive frameworks were built for the benefit of an individual or masses. However, in recent times Behavioural Finance has become a hot topic of research in the investment world, not because the functioning of market players has changed, but amongst the many other utilities, due to increasing adoption of these frameworks in quantitative finance and the so-called "Algos" of AI world are yet to understand the figurative and abstract nature of human behaviour.

"The sum of the square roots of any two sides of an isosceles triangle is equal to the square root of the remaining side." …… Homer Simpson

"That's a right triangle, you idiot!" ….. someone offscreen tries to correct him

Professor Andy Lo of MIT in his book "The Evolution of Technical Analysis" mentions "Technical analysis is really a form of human pattern recognition, which is another application of behavioural finance". And as per one of a leading and well-respected quantitative trader "Technical Analysis is nothing but the graphical representation of mathematical models". In essence, all these short-term oriented trading communities are looking out for an opportunity to exploit human behaviour.

Daniel Kahneman mentions "two systems" of the human mind. System 1, or fast thinking, operates automatically and quickly with little or no effort and no sense of voluntary control. System 2, or slow thinking, allocates attention to the mental activities that demand effort, such as complex computations and conscious, reasoned choices about what to think and what to do. When a human being is awake, both the systems are functioning. System 1 runs automatically, but system 2 idles because using it requires effort and is tiring. The systems operate to minimize effort and maximize performance and are the result of hundreds of thousands of years of human evolution in our environment. Both the systems work absolutely fine except that system 1 has two weaknesses: it is prone to making systematic errors "biases" and it can not be turned off. System 2 can over-rule these biases, but the weakness of system 2 is that it is very poor at recognising these errors and thus the tendency of human biases.

But the reason we are discussing human cognitive biases is that these very same biases create opportunities for us longer-term investors. Remember, it's the fundamentals of a company that has always mattered and will continue to matter from the perspective of wealth creation for the shareholders. As investment professionals, we come across many such cases from time to time. For example, yesterday one of our holding "STMicroelectronics" held its capital markets day, an event during which the company management reviews its strategic policies and sets mid-term i.e., 3 years targets on their respective KPIs.

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STMicro released the press statement in the morning with details of agenda of the day and new mid-term targets wherein they mentioned their previous target of reaching EUR 12 billion of sales is being delayed by one year and the operating margins are estimated to be 2% lower than previously guided. The rationale behind the lower sales and profitability was the US-China trade war, investment into new technologies and Covid-19 impact on the world economy.

Now, STMicroelectronics' CMD and analyst Q&A was still on-going and we already saw a note by a sell-side analyst claiming Quote- Likes of STMicro needs greater ambition, scale to adopt progressive fab-lite models and "go bold or go home"- Unquote. We are not a semiconductor industry expert/veteran nor do we intend to sound like so and with all due respect to this gentleman, this is clearly his system 1 thinking. Why? In our opinion having a fab-lite model is an ideal operating model in a world where technologies have matured, not when there is a tectonic shift ongoing. Because that very fab-lite model could be turned your competitive disadvantage by (1) your bigger competitor intentionally choking the value chain, (2) in extraordinary situations like the one we are currently facing, or (3) huge demand for the product, which is usually always the case when newer technologies are being launched. Moreover, STMicro's historical expertise lies in ASIC model which requires significant control over the value chain. During the earlier part of this past decade, ASIC operating model had gone out of fashion as the technologies matured, but that has changed recently as the world moves towards adopting 5G, IoT, and ESG themes, and rightly STMicro has shown it's credibility by winning contracts with Blue chip names working actively in these fields.

Another one, this gentleman from a well-respected global research house published his note a day earlier Quote - The company has guided to $12bn in sales in the mid-term and we believe they will see those sales on a run-rate basis by 4Q21 or mid '22 – Unquote. This house has been a bit sceptical on the STMicro story in the beginning of the year citing that, it had almost 4 % of its sales coming from one Chinese customer who could face the US wrath. Fair enough. But after watching STMicro beating estimates quarter after quarter, he did not want to be left behind and turned so bullish that he pulled forward the company's earlier guidance by almost a year. On the day of the CMD this analyst releases another note Quote- Our concern was not the cut but the reasons why the company did not do this in Sept when the market was very aware of the Huawei exposure issues- Unquote. And we wondered, why would the company discuss mid-term target at an earning call when the CMD, which meant to discuss exactly the same topics at granular levels, is planned for in two months' time? Although, this gentleman was partly right in his assessment that STMicro has 4% of sales tied to the Chinese customer that faced the US' wrath, where he was not right was on his estimate of future impact. The customer he mentions is the biggest global player active in 5G technology. Given the ASIC operating model of STMicro, the Chinese client must be a bigger factor in the future sales than the current levels. Moreover, given the niche nature of the industry and the size of this customer, we believe that the US ban has affected the entire value chain with different magnitude, not just STMicro.

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We can go on and on, but the point we want to make is when we see these systems 1 reactions from market players with "Disappointment" written all over, us the long-term investors put our system 2 to use to find interesting opportunities like this to enter into a new position or increase weight into an existing one.

We wish you a very nice weekend,

The Team of ECP

December 11th, 2020