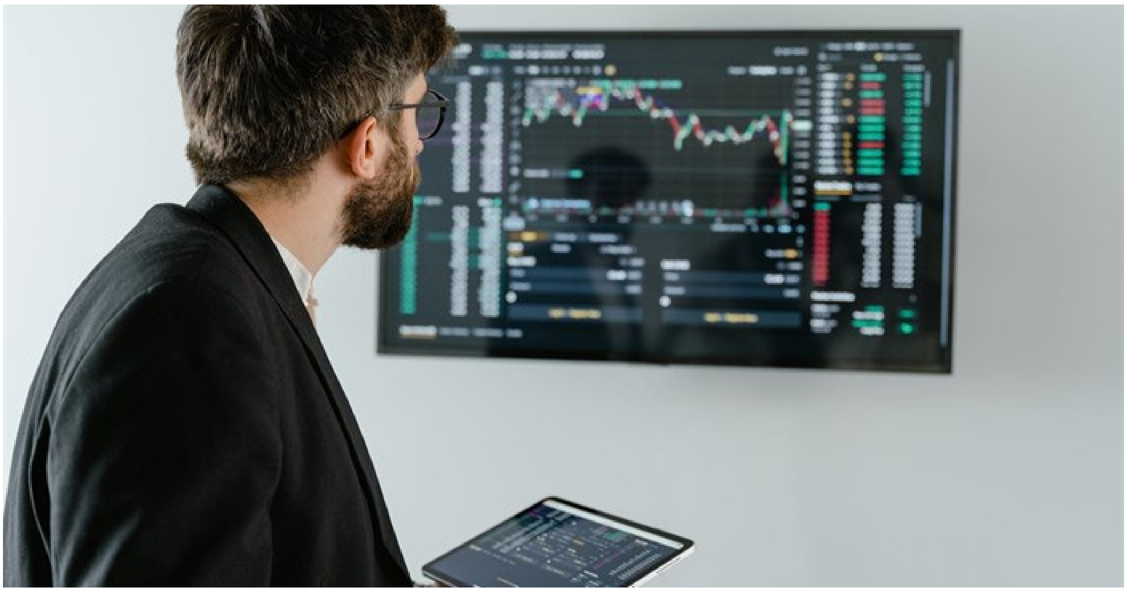
Bizcommunity

Mispricing: an opportunity for investors?

By Adriaan Pask

29 Nov 2021

Risk can sometimes be overestimated when sentiment is poor. Take the chain reaction in the investment community in 2020 when South Africa was downgraded to junk status.



Source: © Tima Mroshnichenko pexels

The prevailing sentiment was that local investment carried with it a substantial risk – an opinion that was priced in by the market.

With the breaking of that news, yields went from 8.5% to 9% and even in some cases to almost 12%, but shortly after, the markets settled down following the downgrade.

A promising opportunity

For strategic investors, mispricing of this kind marks a promising (and potentially lucrative) opportunity.

For example, the US market went through a tapering exercise in 2013. At this point, the market saw bond yields spike from two to three percent.

However, 2014 would see those yields falling once again from three to two percent, marking a significant opportunity and an indication that due to overarching pressure, risk was overestimated.

Reciprocally, the inverse may be true of the current state of US equities, where market sentiment is overwhelmingly positive.

Wall Street equities, for example, recently completed their longest streak of record closing highs since the late 1990s. Stocks and shares have therefore been priced accordingly.

Room for error and mispricing

There's so much good news now, it seems like the market is completely overestimating this aspect and underestimating the risks.

That's something that strategic investment professionals should look out for in the coming months.

What these pricing mechanisms point to, is that markets are highly susceptible to the opinions of individual analysts and fund managers who trade stocks and shares, which often leaves room for error and mispricing.

The influence that sentiment has on the market amidst (and often despite) a myriad of other contributing factors including historical data and geopolitical events, cannot be underestimated.

Mispricing, however, is a phenomenon that opportunistic investors can exploit to their benefit.

Identifying gaps in the markets

Forward-thinking investment professionals need to be able to identify the areas where other investors are potentially making mistakes and then use those mispricing opportunities to generate investment answers for their clients.

A useful rule of thumb is when markets are on the up and opportunities are often overestimated and risks underestimated, all the focus is on the good news.

Contrary to that, when markets are under pressure, what we often see is that the risks are overestimated, and the opportunities underestimated – which then creates some opportunities as well.

To be able to identify these gaps in the market comes down to experience, which should arguably be one of the most important traits to look for when choosing an investment partner like a financial planner, wealth planner or investment manager.

Ultimately, even in markets dominated by technical and sentiment analysis, there is often a case to be made for the importance of experience.

Seasoned advisers who have paid close attention to pricing mechanisms over many years and have dealt with the way that markets overreact to news, will have invaluable insights to share and strategies to develop that are driven by a holistic outlook.

ABOUT THE AUTHOR

Adriaan Pask is the chief investment officer at PSG Wealth.