Honest Answers or Clever Lies?

I work in an industry in which honesty is not a competitive advantage. Buyers of investment product very often prefer clever lies to honest answers. As such, conflicts of interest pervade the investment industry. One could argue they are pervasive in most industries, but I believe Financial Services stands alone in terms of the subtle nature of its conflicts.

For obvious reasons, airline passengers are not permitted to tip the security guard as they walk through the metal detector. My barber is never consulted on the need for a haircut. And I would solicit the opinion on ebooks from someone other than the owner of a bookshop.

These are obvious examples, but in Financial Services the abuse of the chasm in understanding between the buyers and sellers of investment products often manifests itself in very insidious ways. Where you have an asymmetry in information (the seller knowing so much more than the buyer), it fosters undue levels of suspicion.

George Akerlof's "lemons" model provides an interesting perspective. If sellers can evaluate the quality of a used car but buyers cannot, the likely outcome is that both buyers and sellers know that only the worst cars will be traded in the market.

There is a gulf in understanding between the buyers and sellers of investment product. There is deep scepticism of the investment industry. Investors very often assume that all providers are feathering their own nests in some way, which means providers who might prefer to deal honestly know that, most likely, they'll never get credit for doing so.

This short paper is aimed at providing perspectives for both sides of the industry – those that manage and distribute investment product and those that buy it. I have worked on both sides. To the extent that this paper addresses some questions, the answers may not be the right ones, but are at least honest. In an industry beset by clever lies, honest answers can sometimes be uncomfortable.

Charting a course through the investment world

A necessary part of this story requires charting my own career and how I have ended up with the views I now hold about investing. I first encountered the investment business (proper) in 1999, though had worked on the fringes of it for a few years prior to that. I have never managed money (save for my own).

In so far as I may criticise the practices of investors towards the end of this article, I must confess to having done all of the following to varying extents during my 'investment' career, although not within the last five years. To say I am on a learning curve is an understatement.

- Borrowed money to invest in the stock market (albeit in an indirect way)
- Completely eschewed a diversified approach by buying individual stocks
- Solicited the views of fund managers as to their "best ideas"
- Invested in dot-com stocks. Made some. Lost more.

As a declaration of interest currently, I own only one direct share through my pension, bought at a price that is considerably higher than where it is today (anchoring?). All of my other investments are through funds of one sort or another.

Stumbling into value

Buffett referred to value investing as being like an inoculation – it either takes or it doesn't. My immune system put up a good fight! To adapt a phrase from Churchill, "You can always count on investors to do the right thing in the end, but only after they have tried everything else first". I haven't quite tried everything else, but with the benefit of hindsight, I look back at my career (to date) with a wry smile. There was no moment of enlightenment or epiphany; value investing seeped into my unconsciousness over time. I'm still learning, but what I have come to appreciate most is how unpredictable the world really is. At various points over the last fifteen or so years, I naively thought I had figured it out.

Our understanding of the universe is very limited, I believe. We are like the barking dog, trying to understand the world as our masters understand it. There are things going on that we just cannot comprehend. On that basis, value investing has appealed to me most, acknowledging as it does the complexities of our social system, while placing a low level of importance on trying to predict.

The first investment firm I worked at, espoused an investment philosophy that was termed 'growth at a reasonable price', which I now recognise as being a euphemism for 'everything, including value'.

At the time I had heard of, but not really read much about or from, Warren Buffett. In 1998/99 he was been cast as a septuagenarian that had failed to move with the times. Buffett viewed the whole 'dot.com' phenomenon as the great triumph of style over substance. He resolutely refused to invest any of his capital on an idea he fully admitted would change the world, but not the fortunes of those that invested in it (at least not for the better). This stance looked wrong for some time. He had sounded warnings about the tech boom, culminating in a famous address to a symposium in Idaho. In a room replete with famous technology darlings including Steve Jobs, Bill Gates and Michael Eisner, Buffett said the market would either decline significantly or go sideways for twenty years.

I can't quite remember what I thought about this at the time. I probably didn't come across it until many years later, by which time his warnings turned out to be eerily prescient. At that point I am certain I was suffering from hindsight bias as I nodded in agreement with Buffett, wondering how we could have been so stupid, unable as I was to separate what I then knew a number of years later from what I knew before events unfolded. As if history is one long series of inevitable events after another, I berated myself and others for the inability to see what Buffett had seen. It was so obvious!

This investment firm's philosophy morphed over time, though by degrees, where the emphasis on price and risk (in all their forms) became dominant. This company's journey out the value spectrum continued, probably more rapidly after I departed (an effect completely unrelated to the suggested cause).

As I continued to explore the investment universe, I found myself stumbling into a different value investing role. At another investment firm I moved to, I was tasked with marketing a range of value funds drawing on the philosophy and investment principles of people like Joel Greenblatt and James O'Shaughnessy. This was a paint-by-the-numbers approach to value investing, following a simple set of rules. That is, formulaic value as opposed to creative value, as Seth Klarman terms it.

My investment education really developed at this point. In an effort to avoid only reading books which affirmed my already held views about the efficacy of value investing, I read Burton Malkiel's "A Random Walk Down Wall Street".

For a time I have to admit that I found this and the broader efficient markets theory to be quite persuasive; with a dose of "Fooled by Randomness" (Nasim Taleb) mixed in, I was ready to throw in the proverbial towel on active investing all together.

I then read Buffett's 1984 magazine article "The Superinvestors of Graham-and-Doddsville", followed by a whole host of texts with a behavioural finance slant on investing. From that point I reached the following conclusions, the nuances of which will no doubt change over time, but the main theme will remain an anchor: *Despite being a bedrock assumption of finance for sixty years, capital markets are not efficient in the EMH sense, certainly not the strong form efficient. Whilst there is much to learn from this view of finance there are few academics that believe this to be an accurate reflection of the reality.*

And judging by the size of the active management industry, there are even fewer investors that believe this view of the world to be correct. Revisions over the years have chipped away at EMH as a credible theory. Its original evangelists (Fama etc.), have progressively diluted its central tenets, to the point now where they concede that one can earn excess equity return premiums by focusing on small cap and value stocks. They qualify this however, by saying that this is simply reward for extra risk. CAPM and the security market line (SML) hold.

They have yet to explain the anomaly that lower volatility stocks have been shown to produce a return premium also – suggesting the SML is more flat than their theory suggests. In fact, recent evidence from Research Affiliates shows that just about any systematic approach to investing money that removes price from the equation beats the market capitalisation-weighted approach. If you invert low volatility, fundamental and optimised minimum variance portfolios, you get outperformance also.
This cements my view (affirmation bias) that we really haven't figured out how the world works at all. Are we all fools of randomness? As a fellow VII member quipped to me after

seeing the Research Affiliates research, *"Finance is still in Galileos's time where we are debating if the earth orbits the sun or vice versa."*

What is Value Investing?

Despite all this, I am not sure what value investing is. Every fund management firm that I have met, bar a few, seems to emphasise value. It's true – all investing is value investing!

If I was asked to describe what it is, I would struggle, but would probably settle for the following: it is a series of principles that promotes an emphasis on risk before return, a way of thinking about investing that focuses effort on the establishment of the intrinsic value of an asset and then buying that asset at an appreciable discount to that value.

Is there a fund manager in the world that would not subscribe to that view? I guess the distinction between so-called value investors and everyone else will centre on the assumptions made in the assessment of what the intrinsic value is. True value investors, as I would view them, would make very conservative assumptions in that assessment.

Whatever about the nuances of this largely philosophical debate, the distinction between the various investment processes that value investors employ is infinitely more complex. As a demonstration of what a broad church value investing is, here are of some of the practices of current day value investors (captured succinctly in a book by Ronald Chan on interviews with a variety of value managers):

- Some apply screens to narrow down the universe of investable ideas. Others believe this to be naive in an era of massive computing power and largely frictionless access to data.
- Some managers place great value and store in meeting with company management. Others view it as a great distraction – or worse, an exercise that risks developing emotional connections.
- Some managers run very concentrated portfolios – why invest in your 11th best idea, when you can put it in your top-10? Others (or lesser mortals?) recognise the complexities of the world and diversify.
- Some managers place total emphasis on fundamentals and acknowledge price in the latter stages of researching a company. Others emphasise the numbers first and only look at fundamentals in the latter stages.

As if that wasn't complicated enough, now we have to separate the potentially lucky cranks from the unlucky-but-skilled. A focus on value *may* increase one's odds of success, but doesn't preclude one from hiring a 'coin manager' that has been flipped ten heads in a row. Does one just settle for a particular approach, confine the search to a certain sub-segment and hope for the best?

Maybe I should follow Buffett's advice and use passive – he recommends this as an appropriate, low-cost strategy for the majority of investors. Of course, the more people willing to buy companies without reference to fundamentals, the greater the pickings for an active investor like him.

Investment conclusion to all of this

I have settled on the following view of investing: though I would have some strong philosophical issues with passive investing, I believe it has an important role to play in the average investor's portfolio. The naive form of passive, which involves tracking a market cap-weighted index, is not the optimum solution however. There are many alternatives to traditional passive, some of which add a value tilt, which I believe should stack the odds more in investors' favour.

For those with a sufficiently long time horizon, for whom the market's gyrations are viewed more as an opportunity than a risk, I believe a portfolio of value stocks is the most appropriate (and likely profitable) investment choice. The decision then comes down to *which* manager. To rely on various portfolio statistics to determine whether the manager has skill or not is likely to prove fruitless. This part of the process will rely more on 'Art' than 'Science'. An assessment of the investment process, and whether you think the manager has some sort of edge, is inevitably subjective. There are no guarantees; the proverbial leap of faith is required. As Clint Eastwood once said, "If you want a guarantee, buy a toaster."

Investing – a perspective of an investor and his/her fund manager

There is wide spectrum from honesty and integrity, to quiet acquiescence, to gilding the lily and, finally, to outright deceit. Asset gatherers exist at all points along this range. During my time in the asset gathering business, I'd like to think that I have confined myself to the honest end of this spectrum, with any lapse arising out of my own ignorance, rather than any intentional malevolence.

Today I find myself in the fortunate position of not having to toe a party line (or quietly acquiesce). I think I am wiser to the uncertainties that pervade capital markets. Frustratingly, however, I have realised that people (investors) are only willing to hear what they want you to tell them; they prefer clever lies, to honest answers. And there are plenty willing to tell them what they want to hear. A good line of bulls**t goes a long way in this business – probably further than integrity goes, certainly in the short term.

I am continually frustrated by investors' myopic views. However, I think there is culpability for this at every point along the chain from the end investor, to the adviser, the consultants and ultimately the fund manager. Fund managers often deride the average investor for their myopia, pointing to various statistics that show the money-weighted return on equity mutual funds falls far short of the time-weighted return. This is disingenuous at best, given that fund managers seem to have a time horizon that is measured in months rather than years. The average holding period for stocks quoted on the NYSE, now just nine months (GMO statistic, drawing on data going back to 1920), is testimony to that.

A funny story about a doctor and patient comes to mind. In responding to a doctor's advice to wait six months, a patient responds "I don't have the luxury of six months, I don't even buy green bananas at this stage". I can't help but think that investors are cut from the 'green bananas' cloth when it comes to their time horizon.

I recently listened to a fund manager, characteristically unburdened by self-doubt, present his European equity fund to an audience of investment advisers and consultants. He invited the audience to marvel at his track record and the level of outperformance since inception – which was a seven-week period in 2012. In his performance chart he even chose to highlight that the period included the close of business number for the previous day – as if to suggest 24 hours is relevant. Gilding the lily or outright deceit? The fund manager in question surely knows this to be meaningless, in which case he's a fraud. If he doesn't know, he's a fool.

Given that the financial media and airtime been monopolised by vested interests, it should come as little surprise that we are a generation of 'green bananas' investors.

Investors, with the assistance of an adviser (or at least someone unconnected emotionally from the investment), should set out with a proper plan. A well-constructed plan, with a firm anchor in some sort of philosophical belief about markets and how they work (or don't work), will help in steering a course through the inevitable ups and downs. Simple, but not easy!

Conclusion

Abstractly acknowledging that the world in which we live is inherently unpredictable is easy; dealing with this in reality is far more difficult. It is said that medieval monks used to test their commitment to celibacy by lying in bed naked with a woman. Those that contemplate the future face a similar temptation; our minds crave certainty. A value approach requires taking a long-term investment horizon. To enjoy the spoils of this style, one must be immune to the constant gyrations of the market and be wholly indifferent to the prospect of negative returns (which very often arrive in a cluster).

In eighteen years in the business, I think I may have met a small handful of individuals with the emotional wherewithal to qualify at this standard. This alone explains the success of the concept of absolute return (an even broader church than value investing). At the risk of stoking the ire of my fellow Board members, if investors require a smoother journey (to the point where they may even be willing to forego some returns), maybe these should form part of a broader portfolio.

The crux of the debate within the Board of the VII would centre on how one can best approach this. If absolute return is based around a highly-complex, derivative-based strategy, then my colleagues would argue this is the great triumph of hope over experience. An unconstrained value fund that emphasises risk first and return second, one that does not employ shorting or leverage, well that's more their idea of appropriate absolute return.

I am still learning. I know what I don't know. In the investment world, this is a position of power, not weakness. The story goes that the Oracle Delphi had deemed Socrates the smartest man in Athens. Socrates was characteristically sceptical. He was surrounded by smart people who were confident they knew a lot. So he wandered about Athens to question people about what they really knew. He discovered that they were as ignorant as he was, but at least he knew of his ignorance. It was then that Socrates decided that he really was the wisest man in Athens.

For me, there is nothing wrong with having conviction but the most crucial attribute for someone managing my money must be humility (a character trait in short supply in the money management industry) and a recognition of the complexities of the world around them.

Of course to a mind craving certainty, the response "….it could be this, but…." is not an answer at all, honest though it may be. I am not craving certainty. If you are, your *true* investable universe is very small indeed.

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