Inconvenient Truths About Investing

'.. A successful investor must possess a number of seemingly contradictory qualities. These include the arrogance to act, and act decisively, and the humility to know that you could be wrong. The acuity, flexibility, and willingness to change your mind when you realize you are wrong, and the stubbornness to refuse to do so when you remain justifiably confident in your thesis. The conviction to concentrate your portfolio in your very best ideas, and the common sense to nevertheless diversify your holdings. A healthy skepticism, but not blind contrarianism. A deep respect for the lessons of history balanced by the knowledge that things regularly happen that have never before occurred. And, finally, the integrity to admit mistakes, the fortitude to risk making more of them, and the intellectual honesty not to confuse luck with skill.'

Baupost Limited Partners 2015 Year-end letter

The adage 'Investing is simple but not easy', made famous by everybody's favourite investing guru Warren Buffett, is well-known and oft-quoted. Many a professional investors' shelf is adorned with a plethora of books on the subject and academic journals are littered with evidence to assist investors in 'doing the right thing' over the long term. Despite all this plentiful literature and the endless trotting out of 'Chappies wrapper' investment wisdom that comes with it, markets indicate that, as a collective, we humans still behave in a counter-productive manner when it comes to making good investment decisions over time.

Ironically this is precisely what creates the opportunities.

If we were all taking Buffett's advice, such opportunities would cease to exist and the so-called 'value premium' would be eradicated. Long may it last! A small minority of investors do follow the tried and tested ways of unlocking value but it requires independence, conviction and a seriously thick skin to endure the discomfort associated with going against the crowd. Most professional investors simply aren't prepared to endure the pain of being wrong on their own. Sometimes the reason for this is emotional, but more often it's purely practical – being 'wrong on your own' as an asset manager poses a serious threat of losing those clients who, too, dislike the discomfort and don't have the wherewithal required to properly exploit market inefficiencies over time.

Most investors prefer to ignore the inconvenient truths about investing:

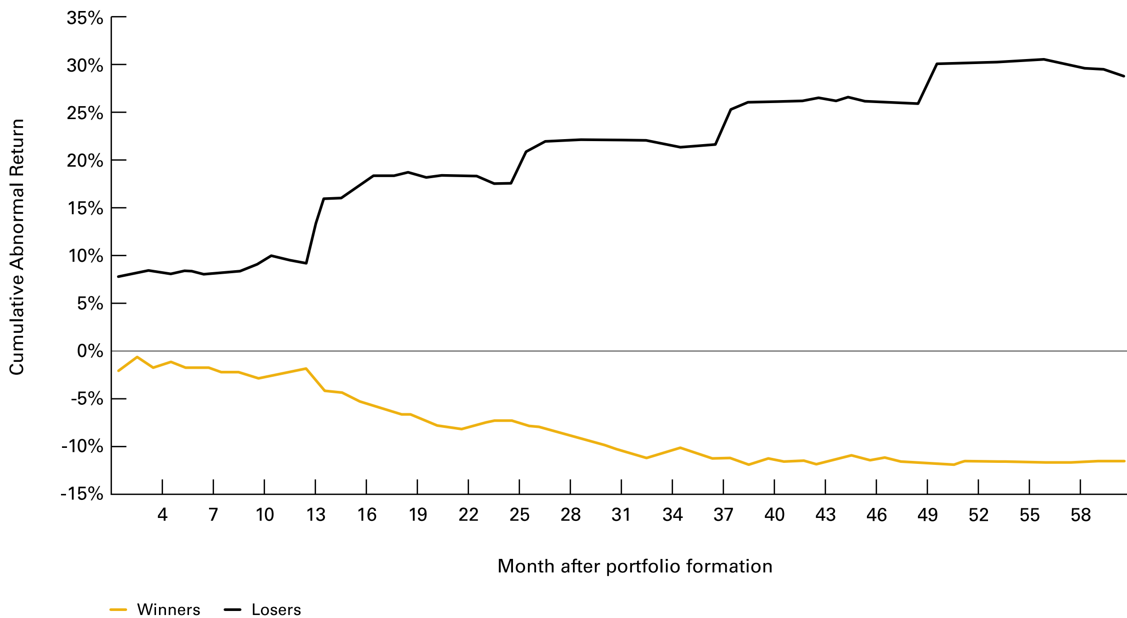
1. Ultimately, the trend is not your friend

The comfort of 'safety in numbers' is an instinct ingrained in us as animals over millennia. And in most cases in life, it's a pretty good survival tactic. Even in investing, going along with the crowd often yields good results in the short run, which then validate and reinforce the behaviour. However, ultimately, we know that following a trend to its conclusion typically leads to a negative outcome in investment terms – particularly if you only jumped on the bandwagon once it was well-established. The simple reason for this is that as emotional human beings we're prone to overreaction. We're prone to being too optimistic when things are going well and being too pessimistic when things are going poorly. This translates into assets which are priced too generously, or conversely, not generously enough. Which means that when those expectations clash with reality, a reversal in price occurs.

As a result, even contrarian investing in its most quantitative form – simply mechanically buying the stocks that have gone down the most over a recent period – has proven more successful than buying the winning stocks historically.

In 1985, DeBondt and Thaler investigated the behaviour of US stocks by constructing a winner portfolio, comprised of the 35 stocks that had

Chart 1: Cumulative Average Returns – Winners and Losers



Source: Damodaran, Bondt and Thaler

gone up the most over the prior year, and a loser portfolio that included the 35 stocks which had gone down the most over the prior year, each year for 46 years from 1933 to 1978. When looking at the returns of these portfolios over the five years thereafter, they found the following:

An investor who bought the 35 biggest losers over the previous year and held them for five years would have generated a cumulative return of approximately 30% over the market and 40% more than the investor who bought the 'winner' portfolio. An important note Damodaran does make, however, relates to the time horizon. While there may be evidence of price reversals in long periods (three to five years), there's evidence of price momentum—losing stocks are more likely to keep losing and winning stocks to keep winning—if you consider shorter periods (six months to a year).

Damodaran says, 'If you want to succeed with this strategy, you have to begin with a long time horizon and a strong stomach for volatility...You will often find yourself losing before you begin winning.'[1] This segues neatly to the next inconvenient truth:

1. Aswath Damodaran book – Investment Fables

2. Drawdowns are almost always inevitable

In the controversially titled piece 'Even God Would Get Fired as an Active Investor', the author (Gray: 2016) assesses the results of a clairvoyant manager (God) who knows ahead of time exactly which stocks are going to be the long-term winners. The implied outsized return is obvious, but what is even more interesting is the gut-wrenching drawdowns investors would have to endure to get there. The title suggests that even God, knowing full well the long-term favourable outcome, would get fired prematurely by his clients because of the discomfort associated with the negative returns along the way.

The study looked at the performance of a portfolio comprised of the top decile of performing stocks over the subsequent five years, and then rebalanced again with the winners of the next five years – this was done with a substantial time frame, using data from 1926 to 2009. To be clear, at the start, this assumes that you know with 100% certainty what the top-performing stocks are going to be over the next five years and structure your portfolio accordingly.

It won't come as a surprise that this portfolio substantially outperformed the market. It returned

Table 1: Ten Worst Drawdowns on Rebalanced Five-Year 'Winners' Portfolios 1926 to 2009

Rank	Date Start	Date End	5-Year High MOM VW	SP500
1	08/30/1929	05/31/1932	-75.96%	-84.59%
2	03/31/1937	03/31/1938	-44.04%	-51.11%
3	05/31/2008	02/28/2009	-42.18%	-45.72%
4	03/31/2000	03/31/2001	-34.03%	-21.48%
5	10/31/1973	09/30/1974	-30.74%	-38.91%
6	08/31/1987	11/30/1987	-27.94%	-29.58%
7	03/31/1962	06/30/1962	-23.35%	-20.64%
8	11/30/1980	09/30/1981	-22.89%	-13.69%
9	12/31/1974	02/28/1975	-22.11%	19.94%
10	09/30/2002	11/30/2002	-19.91%	15.28%

Source: Gray, W 2016. 'Even God Would Get Fired as an Active Investor' available at: http://blog.alphaarchitect.com

Table 2: Performance of the Ten Best Stocks Over the Last Decade

Ten Best Stocks Over Last Decade	Total Return	Max Drawdown	Standard Deviation	% of time down at least 20%
Priceline Group Inc	5823%	-66.3%	43.1%	14%
Regeneron Pharmaceuticals Inc	4223%	-57.9%	52.0%	33%
Netflix Inc	2794%	-82.0%	56.5%	44%
Alexion Pharmaceuticals Inc	2380%	-37.4%	38.2%	14%
Monster Beverage	1986%	-69.2%	47.3%	53%
CF Industries Holdings Inc	1784%	-76.7%	48.3%	32%
Skyworks Solutions Inc	1696%	-66.0%	51.7%	46%
Keurig Green Mount	1608%	-84.3%	64.6%	39%
Amazon Inc	1505%	-65.3%	42.2%	33%
Apple Inc	1388%	-60.9%	34.5%	29%
Average	2519%	-65.6%	45.4%	34%
S&P 500 Index	109%	-55%	21.0%	20%

Source: Batnick, M 2015. 'Looking for a Ten Bagger?' available at: http://theirrelevantinvestor.com

28.9% per annum in comparison to the S&P500's 9.6% per annum – a staggering, albeit entirely unrealistic, performance.

What was far more notable however, were the drawdowns associated with achieving this return. Remember, the term 'drawdown' refers to the maximum negative return over any one period from peak to trough.

The worst drawdown for the 'crystal ball' portfolio is a devastating -76%! Table 1 ranks the ten worst drawdowns over the entire period.

Think particularly of how God's clients might have felt in instances nine and ten: Where the market was UP 20% while the portfolio was down 22%? What this clearly shows is that conviction, a longer time horizon than most consider and long-suffering patience are essential to maximising returns.

Focusing at the individual share level, in the article 'Looking for a Ten Bagger ?'[2] Michael Batnick shows that unfortunately volatility and big

2. An investment that appreciates to ten times its initial purchase price.

drawdowns are also common traits amongst the market's biggest winners.

Batnick notes the following regarding Table 2:

- Nine of the ten biggest winners more than halved at some stage during the period. Even the best performing stocks gave investors sleepless nights.
- Even though these winners returned more than 23 times what the S&P 500 did, their average standard deviation – an indicator of their volatility – was more than twice that of the S&P500. No pain, no gain.
- On average, these stocks spent 34% of the time in bear market territory (down at least 20% from the previous high).

It would be so much easier to endure such negative returns if we knew they were temporary and that it would 'all turn out okay in the end.' But we don't, because we simply don't and can't know the future – no matter how hard we try. Which leads to the next inconvenient truth:

3. No one can forecast the future

Not knowing what will happen in future is particularly inconvenient when you're investing for the future! Clients ask routinely in presentations not only what will happen in future, but exactly when as well. An answer of 'we just don't know' is usually not considered a satisfactory response, so industry professionals oblige and rattle off their forecasts on a routine basis. The reality however, is that a 'professional' is no better at forecasting the future than the average layperson.

Phil Tetlock, a professor of psychology and political science at the University of Pennsylvania, proved this when he got 284 experts to make more than 27,000 predictions on political, social and economic outcomes over 21 years to 2004. The period included six presidential elections and three wars. All the forecasters had impressive credentials with more than half having PhDs. He then tracked their predictions. The results, summarised in his book 'Expert Political Judgment' were disappointing. The predictions of the average expert were 'little better than guessing,' which is a polite way of saying that they were no more accurate than a dart-throwing monkey.

Interestingly, there was an inverse correlation between fame and accuracy. While famous experts had among the worst records of prediction, they demonstrated 'skill at telling a compelling story'. To gain fame it helps to tell 'tight, simple, clear stories that grab and hold audiences.' These experts were often wrong but never in doubt. (Mauboussin: 2015)

So what to do given the uncertainty of the future? Our conviction is that the best way to protect portfolios against unforeseen negative events is to buy securities, preferably of high quality businesses, and only when they're very cheap compared to what they're worth. We look to fill portfolios with as many diversified investments as we can find so that investment success isn't dependent on any one of these ideas playing out perfectly. Ultimately, all you can do as an investor is put the odds of investment success on your side, despite the uncertainty of the future.

4. There is a negative correlation between fund flows and next period performance

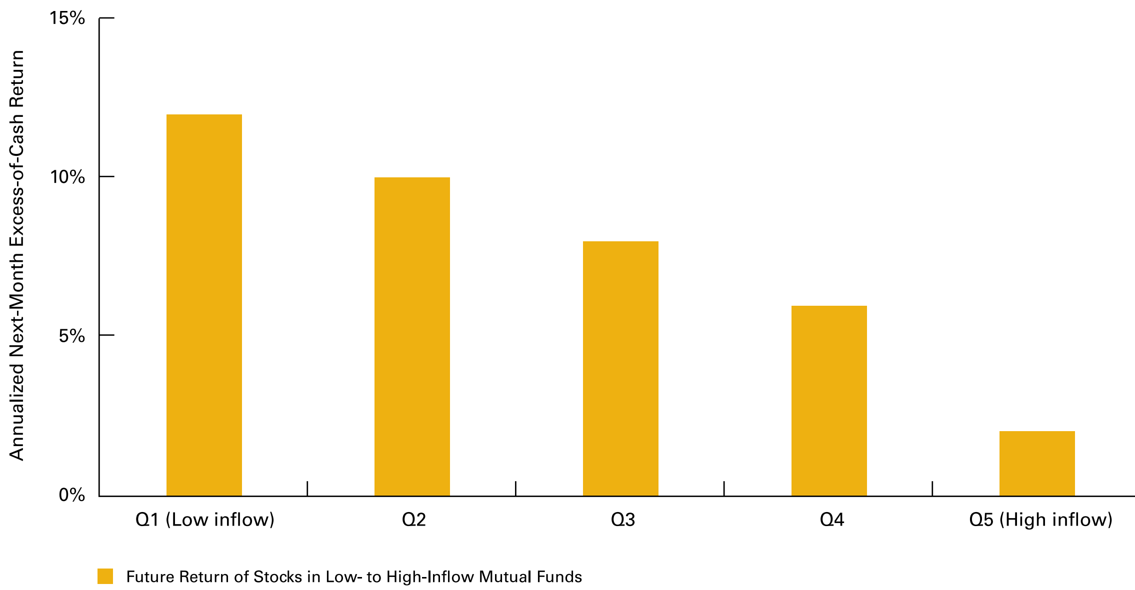
As discussed in the first part of the paper, overextrapolation of past performance combined with herding results in short-term momentum in securities prices. Eventually, the overshooting in prices gives way to a reversal in prices. The same occurs with different investment styles.

Most investors adopt a process for evaluating managers and investment strategies based on the past two or three years of relative performance versus a market-cap weighted index. Strong past performance tends to attract inflows and poor performance leads to outflows.

The flows allocated to the performing managers are then invested in the same stocks, further fuelling their upward trajectory. More managers are attracted to these stocks especially as they become a bigger part of the index against which managers are measured. All of this leads to an increasingly crowded trade which ultimately reverses. Hsu (2015) discusses this phenomenon: 'There is little wisdom in the prices that result, though the madness can certainly persist for a long while, creating the illusion of investment "guru"-ness on the part of many.' Frazzini and Lamont (2008) and Hsu, Myers and Whitby (2015) find evidence that the unit trusts that experience the most inflows, tend to have low next-period relative performance, as the chart below indicates.

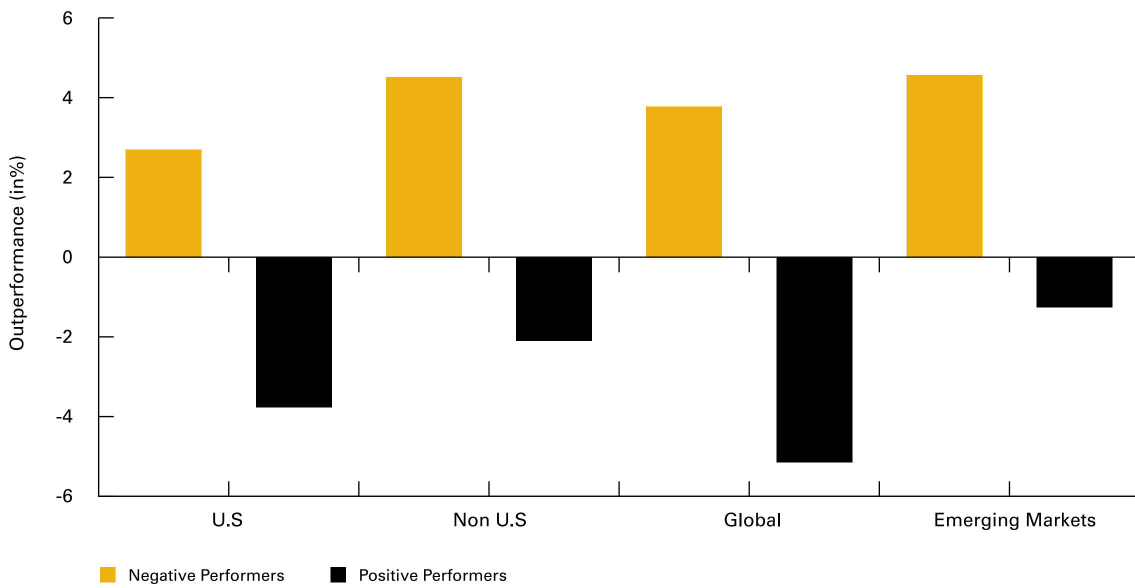
Ironically the pursuit of excess returns, and the switching of investment strategies and managers is the very reason why many unit trust investors

Chart 2: Returns of Stocks in Low vs High-Inflow Funds



Source: Reseacg Affiliates, LLC, based on Frazzini and Lamont (2008) data. Measurement period 1980-2003

Chart 3: Past Five-Year Performance vs. Previous Five-Year Performance



Source: eVestment Alliance, Hewitt Ennis Knupp Blog Weekly Update, September 25, 2013

end up with poorer returns than they would have earned otherwise. Effectively, investors – without realising it – are attempting to time manager alpha. Chart 3 shows however that managers who have underperformed in the previous five years tend to outperform in the next five years, while the outperformers tend to underperform thereafter.

As manager styles come in and out of favour, the attempt to time them by allocating away from those who have underperformed in favour of those who have done well historically generally leads to the opposite of the desired effect.

Conclusion

When investors behave in a similar fashion, we generally see big moves up or down and a resulting deviation between the fundamentals of the underlying businesses and the expectations of investors. This results in market inefficiencies which can be exploited to generate great long term returns. However, the most inconvenient truth of all is that the very factor that causes this market inefficiency—correlated beliefs—makes exploiting that inefficiency very difficult. The desire to be part of the crowd is a powerful one, and being apart from the crowd is scary and ultimately unpalatable for most.

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