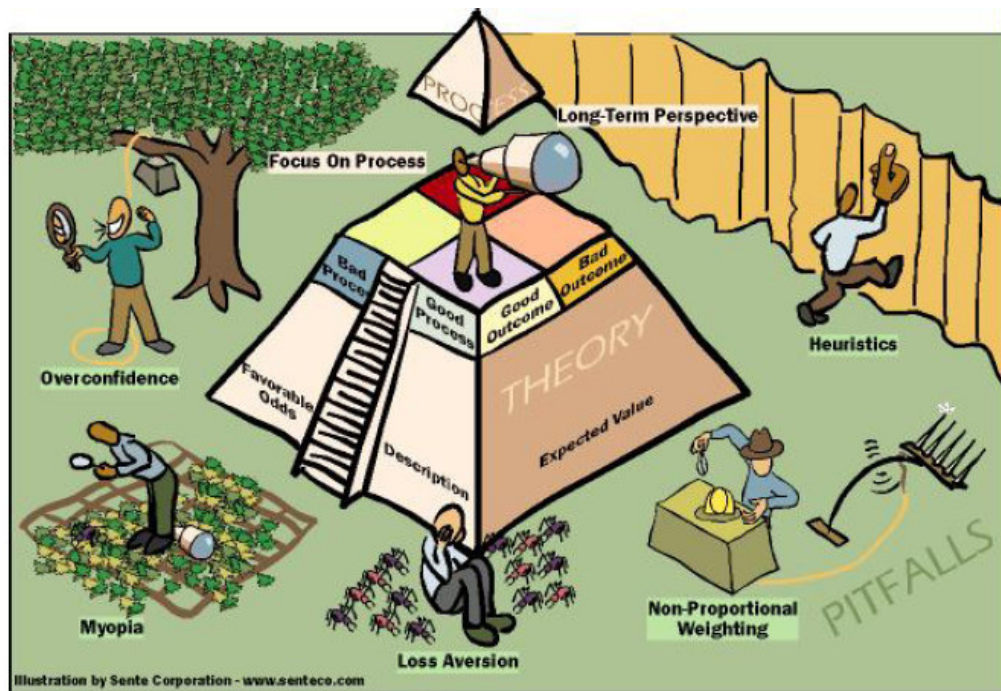




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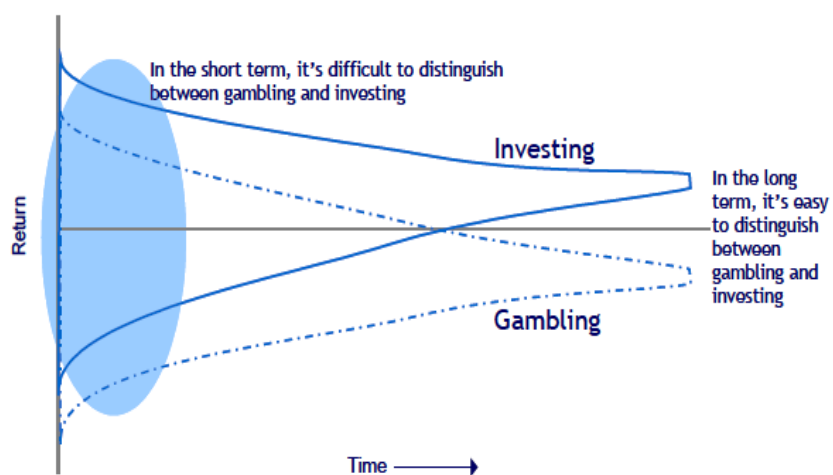
Source: Mauboussin, 2004: Decision-Making for Investors

The Elements of a Good Investment Process

By Daniel R Wessels

The outcome of a probabilistic activity like investing can be either good or bad, especially when considered from a relative short-term perspective. Many studies researching sport, business and investing activities indicated that a good, consistent process is the key differentiator between favourable and less favourable outcomes over time. Alternatively, it is more likely that sport teams, businesses and investors following sound, consistent, systematic processes and practices will experience more successes than failures over time. However, as individuals we tend to focus solely on specific outcomes, as if such outcomes can be fully controlled in competitive environments (i.e. the role of luck or good fortunes is ignored in the outcome), or that one outcome is the final judicator of a particular strategy, i.e. in another period in time the fortunes may actually reverse for the better or worse.

Successful long-term investors tend to have some traits or skills in common. For example, a passion to learn more about their investment (or unless they have a good idea and understanding about their investment they will not easily commit to it), a willingness to take some risk but understand the odds of different outcomes), patience to wait for their strategy to come to fruition and perhaps very importantly, a clear distinguishing in their minds between investment and speculation. Such investors know that the passage of time will turn the odds in their favour, unlike gambling that for the great majority of participants will be a negative sum game over time.



Source: Mauboussin, 2004.

Moreover successful investors focus on the investment process they follow and understand that investment outcomes over the short term may be very misleading and even unjustifiably reward some lucky investors or penalise the more prudent investors. For example, it is quite possible that two investors – one skilled and following a systematic process while the other is

blindly following some “hot tips” from friends – achieved similar results over a certain period. However, one would find that the more skilful investor will outperform the less skilled (no-process) investor over more investment periods and thus the longer term.

Process and Outcome Matrix

Investment process	Good outcome	Bad outcome
Good process	Deserved success	Bad break
Bad process	Dumb luck	Poetic justice

Source: Mauboussin, 2004

Thus it may be worthwhile for any investor to acquire knowledge how to develop a good investment process, or when the investor is outsourcing the investment decision to a professional investor (fund manager) at least has some idea what a good investment process should entail. Let us review the basic elements of a good investment process and I quote from the excellent research that Michael Mauboussin (2010), Chief Investment Strategist at Legg Mason Capital Management, and one of the world’s leading experts in Behavioural Finance, did on the subject over the years:

Skill in investing, like other probabilistic activities, is a process that incorporates analytical, psychological, and organizational considerations. If luck nets to zero over time—you win some, you lose some—then long-term results depend on the process.

You can think of skill in three parts. The first part requires you to find situations where you have an analytical edge and to allocate the appropriate amount of capital when you do have an edge. The financial community dedicates substantial resources into trying to gain an edge but less time on sizing positions so as to maximize long-term wealth.

At the core of an analytical edge is an ability to systematically distinguish between fundamentals and expectations. Fundamentals are a well thought out distribution of outcomes, and expectations are what is priced into an asset. A powerful metaphor is the racetrack. The fundamentals are how fast a given horse will run and the expectations are the odds on the tote board. As any serious handicapper knows, you make money only by finding a mispricing between the performance of the horse and the odds. There are no “good” or “bad” horses, just correctly or incorrectly priced ones.

An analytical edge exhibits certain characteristics. For example, assessment of the fundamentals should be consistent with the principles of economics, especially microeconomics. Investors need to grasp notions like supply and demand, economic profits, and sustainable competitive advantage.

An edge should also incorporate the outside view rather than relying on the inside view. With the inside view, decision makers tend to gather information about a topic, combine it with their own inputs, and project into the future. In most cases, the inside view leads to conclusions that are too optimistic. By contrast, the outside view asks what happened when others were in a similar situation before. By leaning more on historical base rates than on individual extrapolation, the outside view provides a better grounding for analysis.

An analytical edge should also be repeatable in different environments. This does not mean that an investor must always find an edge; there will be times when the set of potential investments will be limited by either the investor's correct realization of the limits to his or her competence or by a lack of attractive opportunities. It does mean that the approach to finding an edge will be steadfast over time and can be applied to various industries or asset classes.

Onlookers frequently confuse edge with style. When a certain style is doing well, a manager using that style will fare favorably whether or not he or she actively chose that exposure. Over time, some factors have generated excess risk-adjusted returns. For example, small caps have delivered higher returns than large caps since the mid 1920s. But these long-term results mask the existence of extended periods when those factors don't work. If you had bet on small caps going into the 1980s and 1990s, as an illustration, you would have fared worse than the S&P 500.

Edge means generating excess returns because of mispricing. Style suggests being in the right place at the right time. Sometimes edge and style overlap, sometimes they don't.

Edge also implies what Ben Graham, the father of security analysis, called a margin of safety. You have a margin of safety when you buy an asset at a price that is substantially less than its value. As Graham noted, the margin of safety "is available for absorbing the effect of miscalculations or worse than average luck." The size of the gap between expectations and fundamentals dictates the magnitude of the margin of safety. Graham expands, "The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price."

The second challenge is to properly build portfolios to take advantage of the opportunities. There are two common mistakes in sizing positions within a portfolio. One is a failure to adjust position sizes for the attractiveness of the opportunity. In theory, the positions in more attractive risk-adjusted opportunities should be more prominent in the portfolio than less attractive opportunities. In some activities, mathematical formulas can help work out precisely how much you should bet given your perceived edge. While this is difficult in practice for most money managers, the main idea remains: the best ideas deserve the most capital. The weighting in many portfolios fails to distinguish sufficiently between the quality of the ideas.

The other mistake, at the opposite end of the spectrum, is overbetting. In the past, funds that have seen their edge dwindle have boosted returns through leverage. This led to position sizes that were too large for the opportunity and ultimately disastrous in cases when the trade didn't perform as expected. The failure of Long-Term Capital Management is one of the best-documented cases of the perils of overbetting. The analytical part of a good process requires both disciplined unearthing of edge and intelligent position sizing aimed at maximizing long-term risk-adjusted returns.

The second part of skill is psychological, or behavioral. Not everyone has a temperament that is well suited to investing, and skillful investors approach markets with equanimity. One such skilled investor is Seth Klarman, founder and president of the highly-successful Baupost Group, who shared a wonderful line: "Value investing is at its core the marriage of a contrarian streak and a calculator."

A large source of mispricing is when the collective becomes uniformly bullish or bearish, opening large gaps between expectations (price) and fundamentals (value). The first part of Klarman's line emphasizes the importance of the willingness to go against the crowd. Academic research confirms what most people know: it is easier and more comfortable to be part of the crowd than it is to be alone. Skillful investors heed Ben Graham's advice: "Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ." However, Klarman correctly observed that it is not enough to be a contrarian because sometimes the consensus is right. The goal is to be a contrarian when it allows you to gain an edge, and the calculator helps you ensure a margin of safety.

Exposure to diverse inputs is crucial to developing sound contrarian views. As an idea takes hold in the investment community, it tends to crowd out alternative points of view. Skillful investors constantly seek input from a variety of sources, primarily through reading. Phil Tetlock, a psychologist who has done groundbreaking work on the decision making of experts, writes that "good judges tend to be . . . eclectic thinkers who are tolerant of counterarguments."

This part of the process also acknowledges, and takes steps to mitigate, the biases that emanate from common heuristics. These biases include overconfidence, anchoring, the confirmation trap, and the curse of knowledge, to name just a few. Overcoming these behavioral pitfalls is not easy, especially at emotional extremes. Techniques that are helpful include expressing views in probabilistic terms, constantly considering base rates, and maintaining a decision-making journal.

The last component of this part is maintaining what I call a “Mr. Market” mindset. To express a proper attitude toward markets, Ben Graham created the idea of Mr. Market, a “very obliging” fellow who offers to sell his shares to you or to buy yours. Mr. Market shows up every day, but is sometimes very optimistic and, fearful that you will snatch his shares at a low price, posts a very high price. On other occasions he is distraught, and seeks to dump his shares at a bargain-basement price.

Graham’s main lesson is that Mr. Market is there to serve you, not to educate you. You cannot let the prices entrance you. Graham writes, “Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.” This is easy to say but requires a lot of skill to do.

The third part of the process of skill addresses organizational and institutional constraints. The core issue is how to manage agency costs. Costs arise because the agent (the money manager) may have interests that are different than the principal (the investor). For example, mutual fund managers who are paid fees based on assets under management may seek to prioritize asset growth over delivering excess returns. Actions to serve this priority may include heavily marketing products that have been recently successful, launching new products in hot areas, and managing portfolios to look similar to their benchmarks.

Charley Ellis made this point when he distinguished between the profession and business of investing. The profession is about managing portfolios so as to maximize long-term returns, while the business is about generating earnings as an investment firm. Naturally, a vibrant business is essential to support the profession. But a focus on the business at the expense of the profession is a problem. Stated differently, you want the investment professionals focused intently on finding opportunities with edge and building sensible portfolios.

Career risk is also important. Investment managers seeking long-term excess returns will frequently have portfolios that are very different than the benchmark and that have high tracking error. If the time horizon of either the investment company or the clients is shorter than the time horizon necessary to see the fruition of the investment approach, even skilled managers risk getting fired. Professional investors have learned to play close to the index.

All three parts of investing skill are difficult. Many organizations clear one or two of the hurdles, but few can clear all three. This fits with the conclusion of our analysis of skill and luck in investing: there are differential capabilities, but only a handful of investors can clear the analytical, psychological, and organizational hurdles.

Sources:

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