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North America | Europe | Asia-Pacific

Ten Lessons (Not?) Learnt

James Montier

Asset Allocation

Lesson I: Markets aren't efficient

A long litany of bad ideas:

CAPM

Alpha and Beta

Black and Scholes

Risk management

Mark-to market

M&M dividend and capital structure irrelevance

Shareholder Value

Regulatory regime

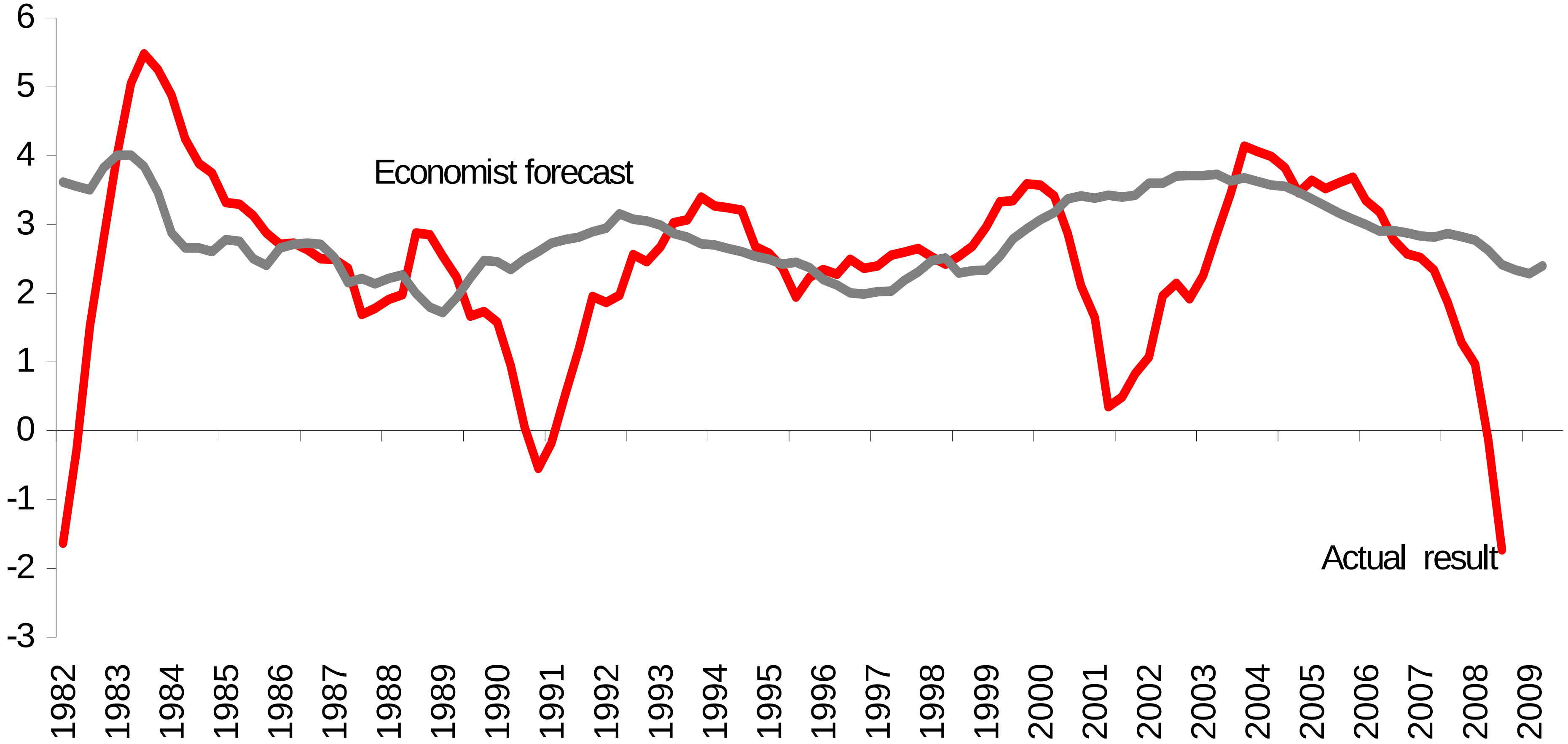
Most insidious aspects of EMH are the advice on sources of outperformance

Inside information (illegal in most places)

If you can see the future better than everyone else

Also tells us that opportunities will be fleeting

Not a drop of evidence that we can forecast anything at all



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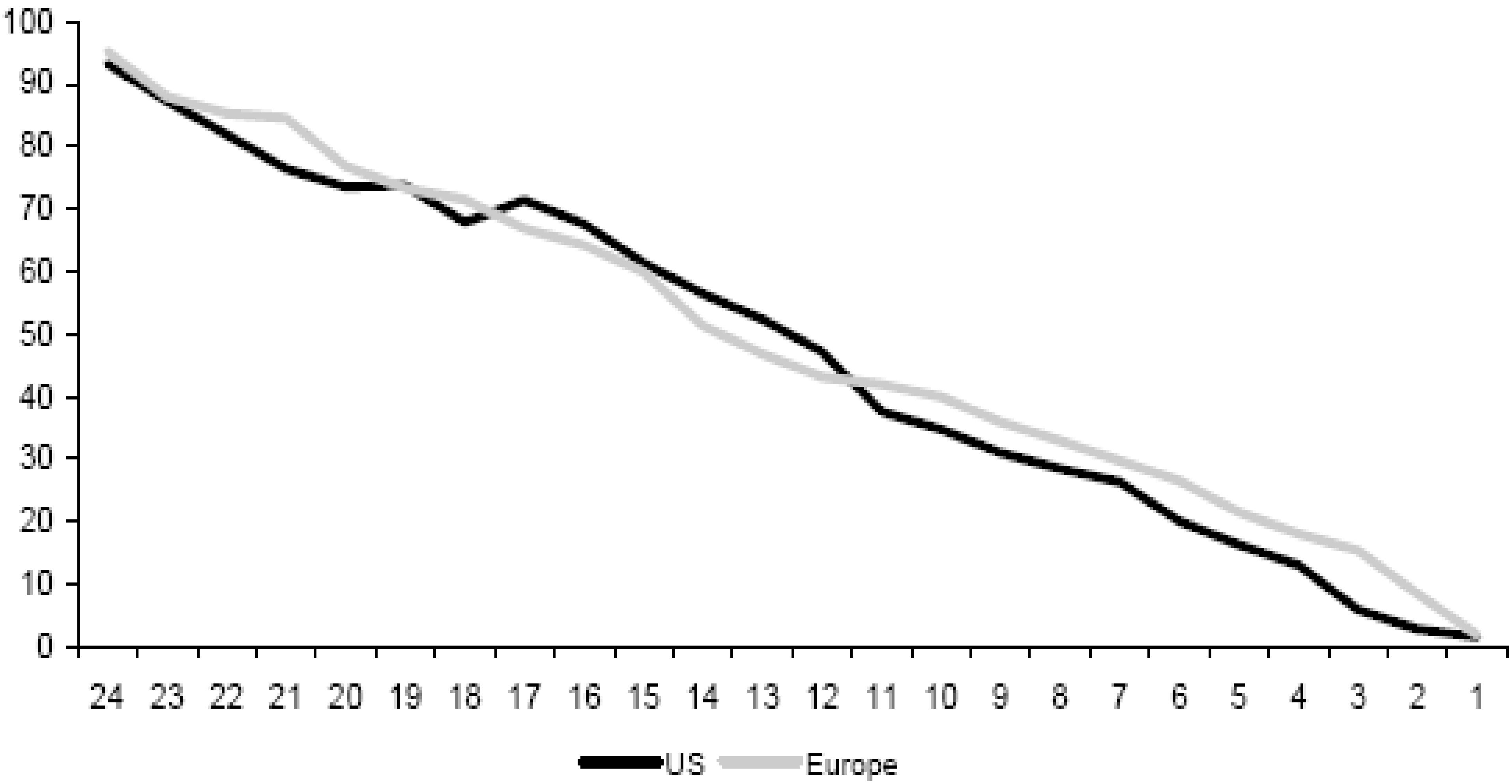
Forecast error over time: US and European markets 2001-2006, %



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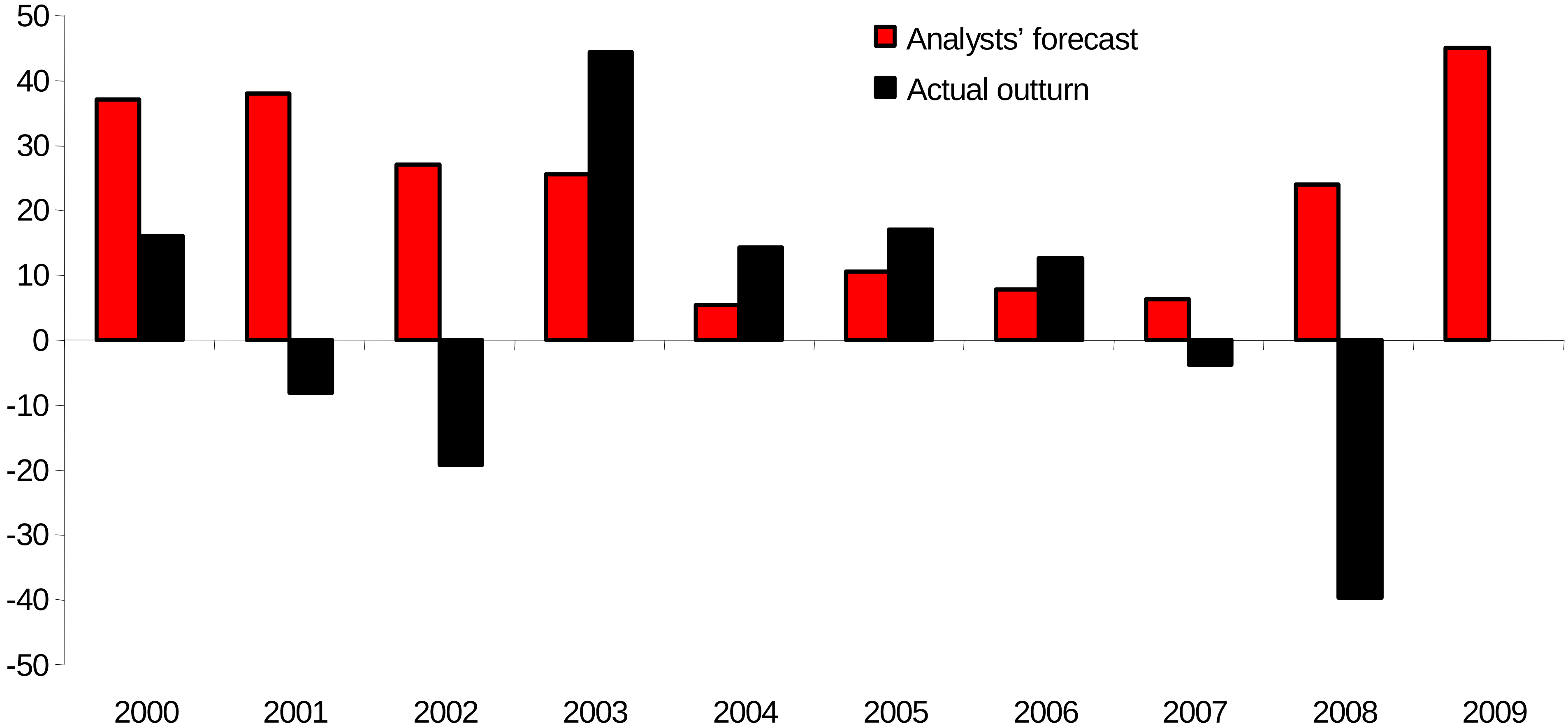
Analyst expected returns (via target prices) and actual returns (US, %)



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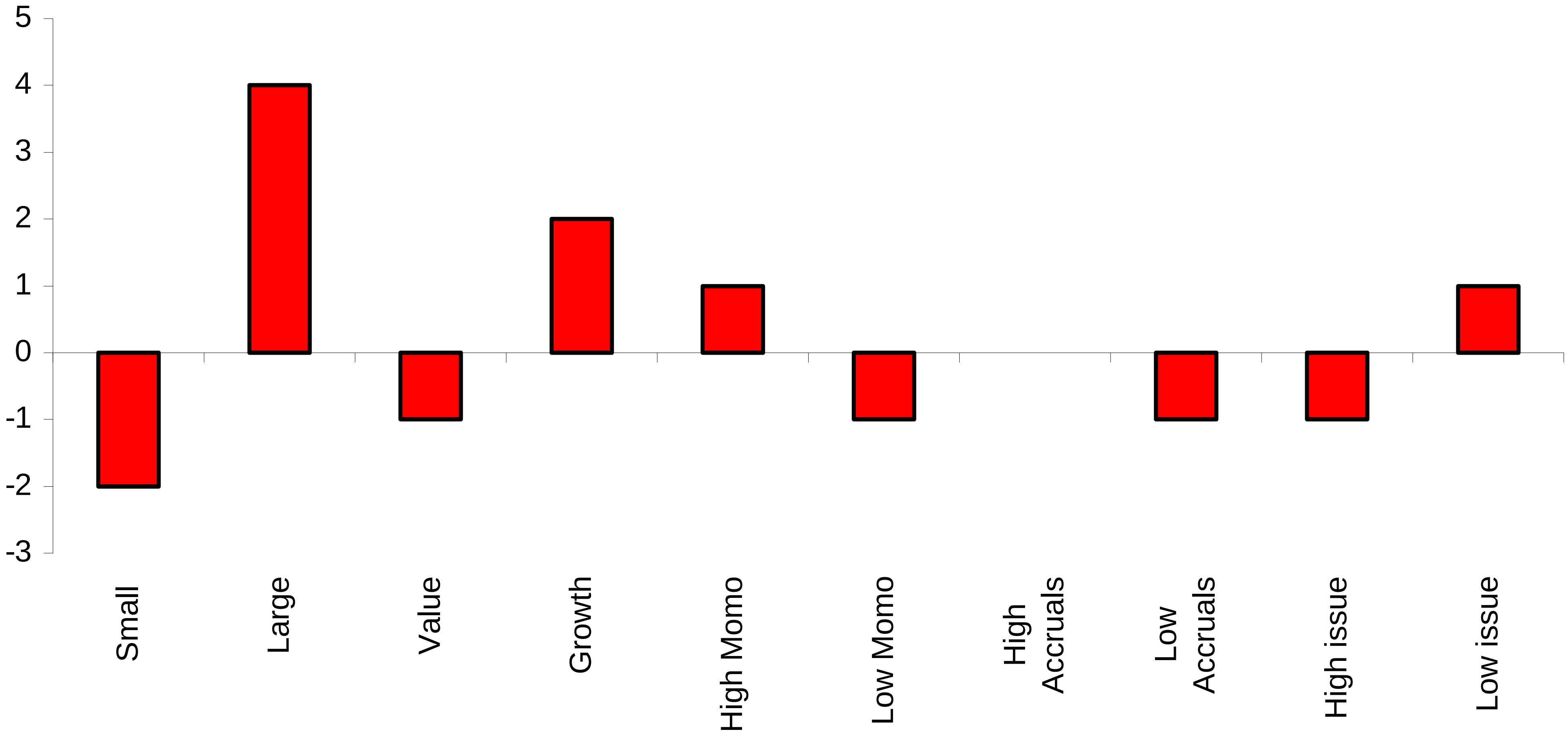
Lesson II: Relative Performance is a dangerous game

Homo Ovinus

Institutional investors vs. US market (weight difference)



Source: Lewellen (2009)

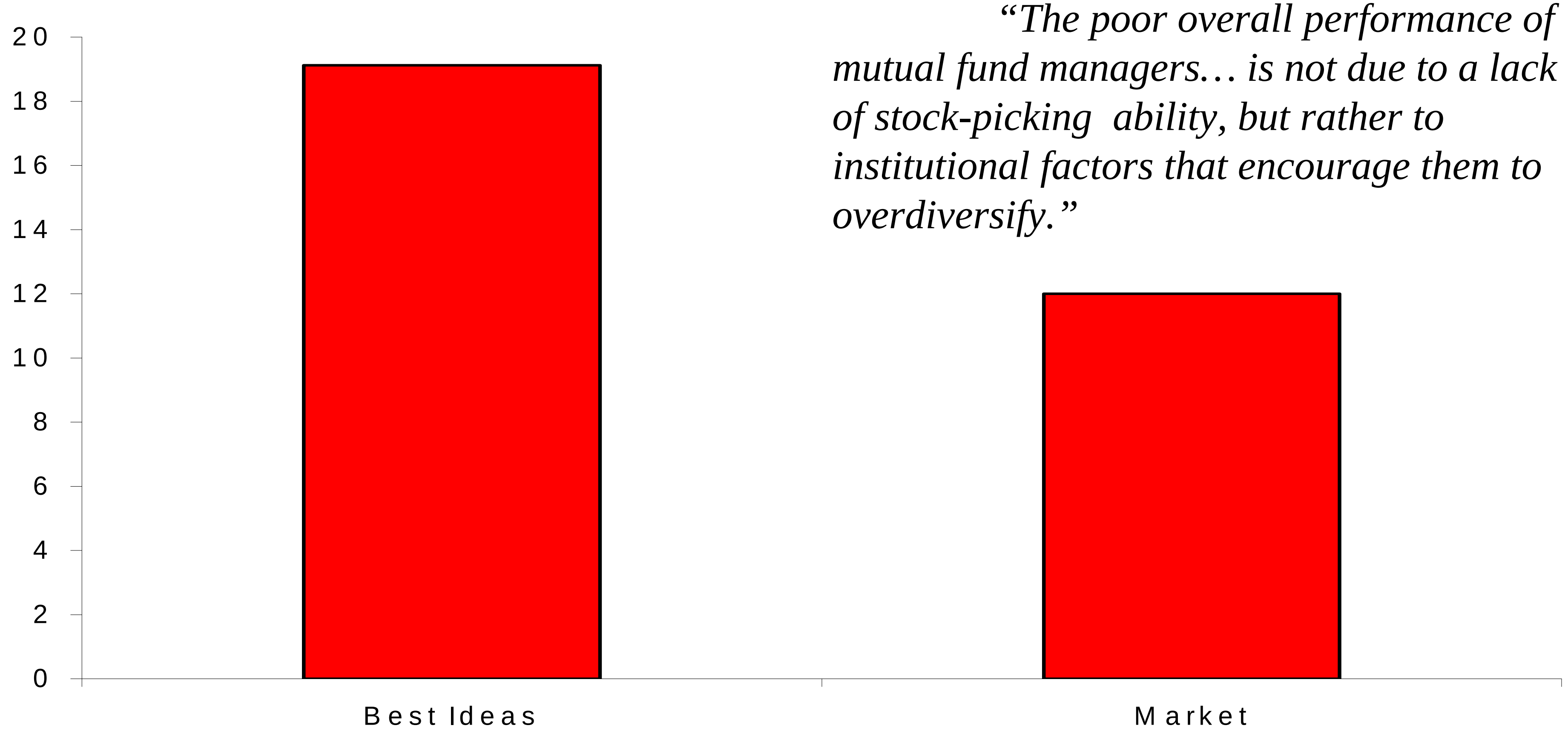
Many active managers aren't even trying!

Lewellen concludes:

"Quite simply, institutions overall seem to do little more than hold the market portfolio. Their aggregate portfolio almost perfectly mimics the value-weighted index... Institutions overall take essentially no bet on any of the most important stock characteristics known to predict returns, like B/M, momentum, or accruals. The implication is that, to the extent that institutions' holdings deviate from the market portfolio, they seem to bet primarily on idiosyncratic returns – bets that aren't particularly successful. Another implication is that institutions, in aggregate, don't exploit anomalies in the way they should."

Why not? Career and Business risk (Homo Ovinus rides again)

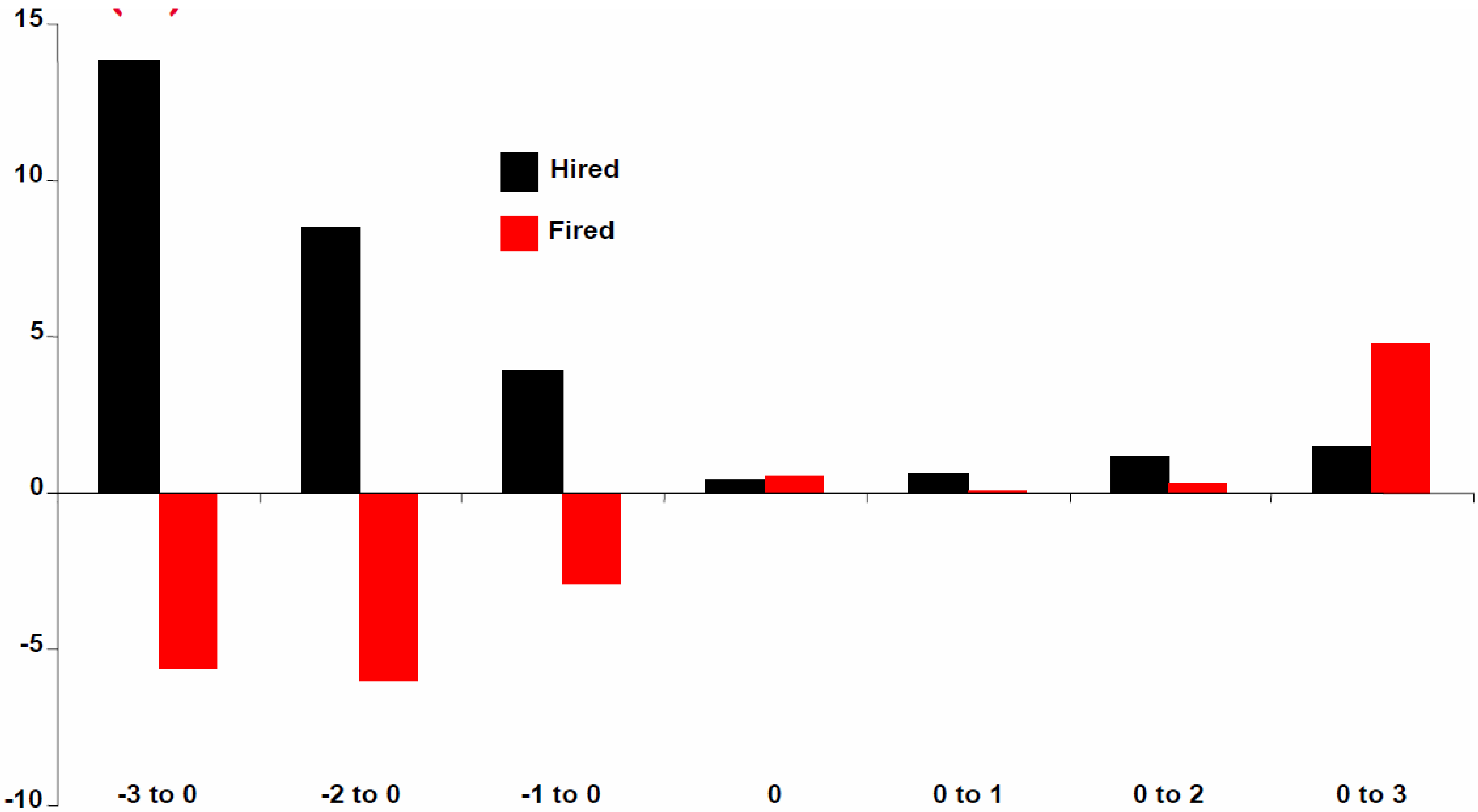
Cohen et al 'Best Ideas'



Cohen et al conclude

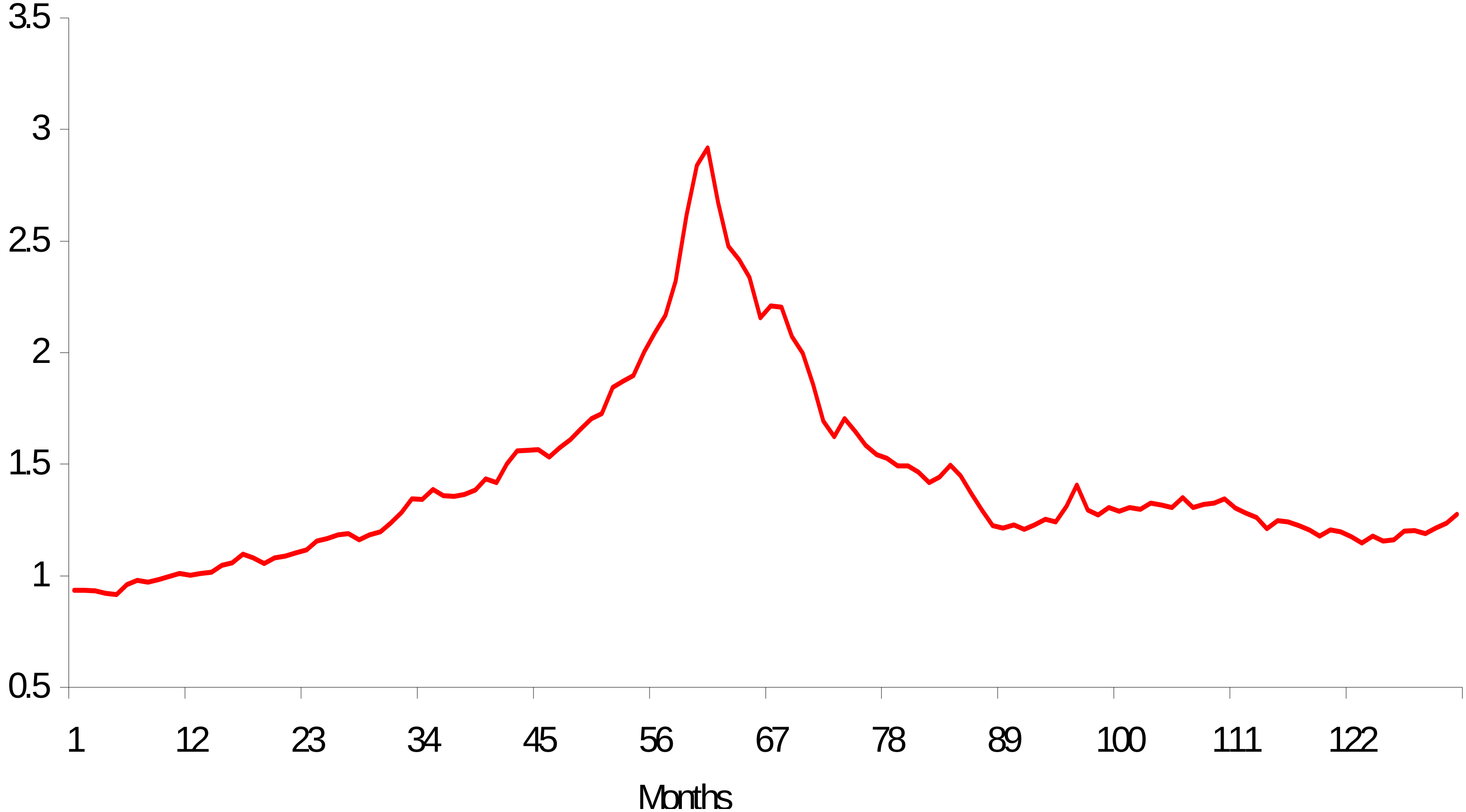
"The poor overall performance of mutual fund managers… is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to overdiversify."

Performance around hiring and firing decisions (%)



Source: Goyal and Wahler

Lesson III: This time is never different



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Mill/Minsky/Kindleberger framework for bubbles

Displacement

↓

Credit Creation

↓

Euphoria

↓

Critical Stage/Financial Distress

↓

Revulsion

Why don't we see bubbles?

Black Swans

- Unpredictable
- Massive Impact
- Ex-post rationalization

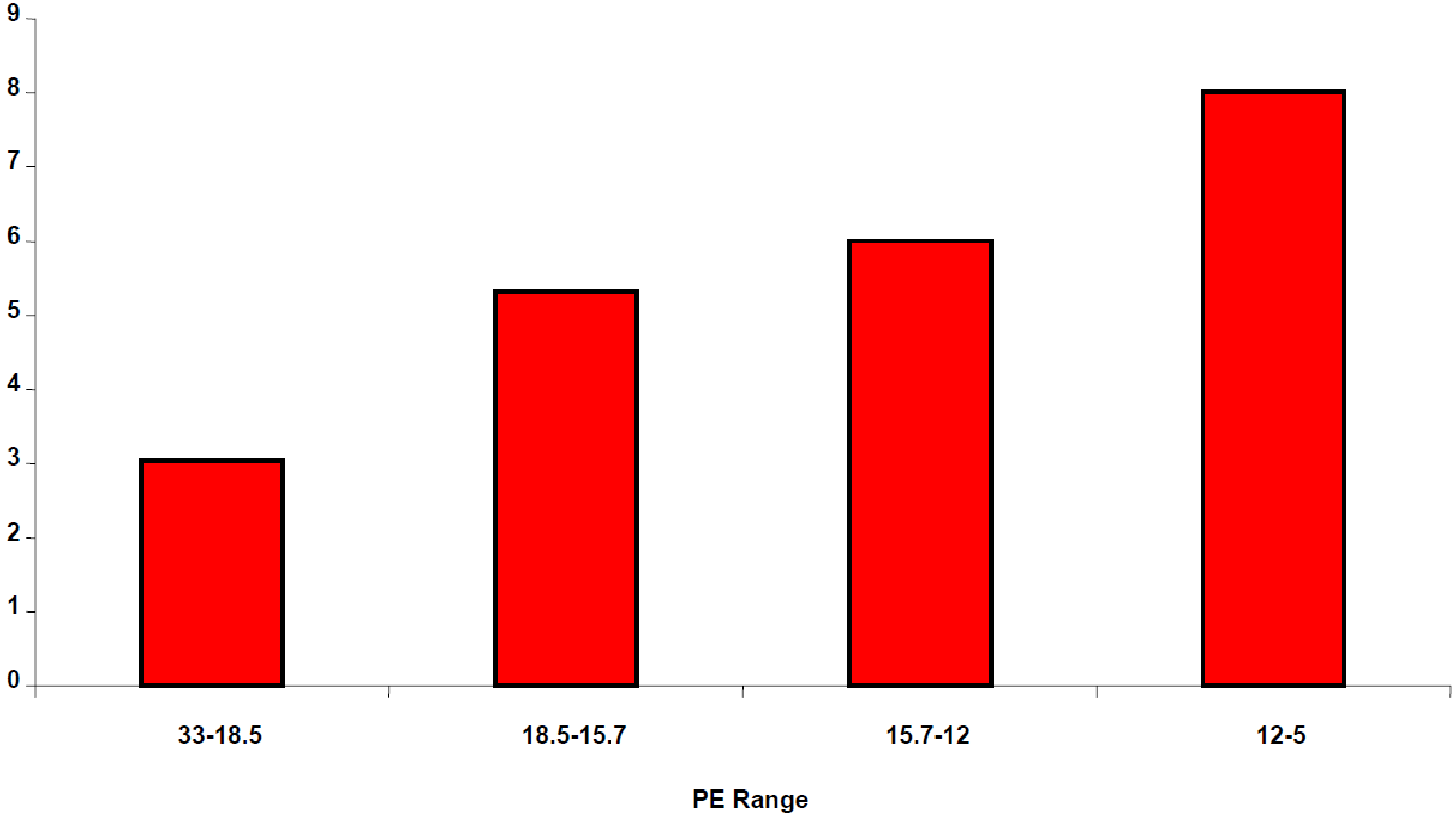
Predictable Surprise

- At least some where aware of the problem
- The problem gets worse over time
- Eventually explodes into crisis

Five impediments to recognising predictable surprises:

(i) Over-optimism
(ii) The illusion of control
(iii) Self-serving bias
(iv) Myopia
(v) Inattentional blindness

Lesson IV: Valuation Matters (in the long run)



Source: GMO

Buy when it’s cheap: if not then, when?

Buying at 10x G&D PE

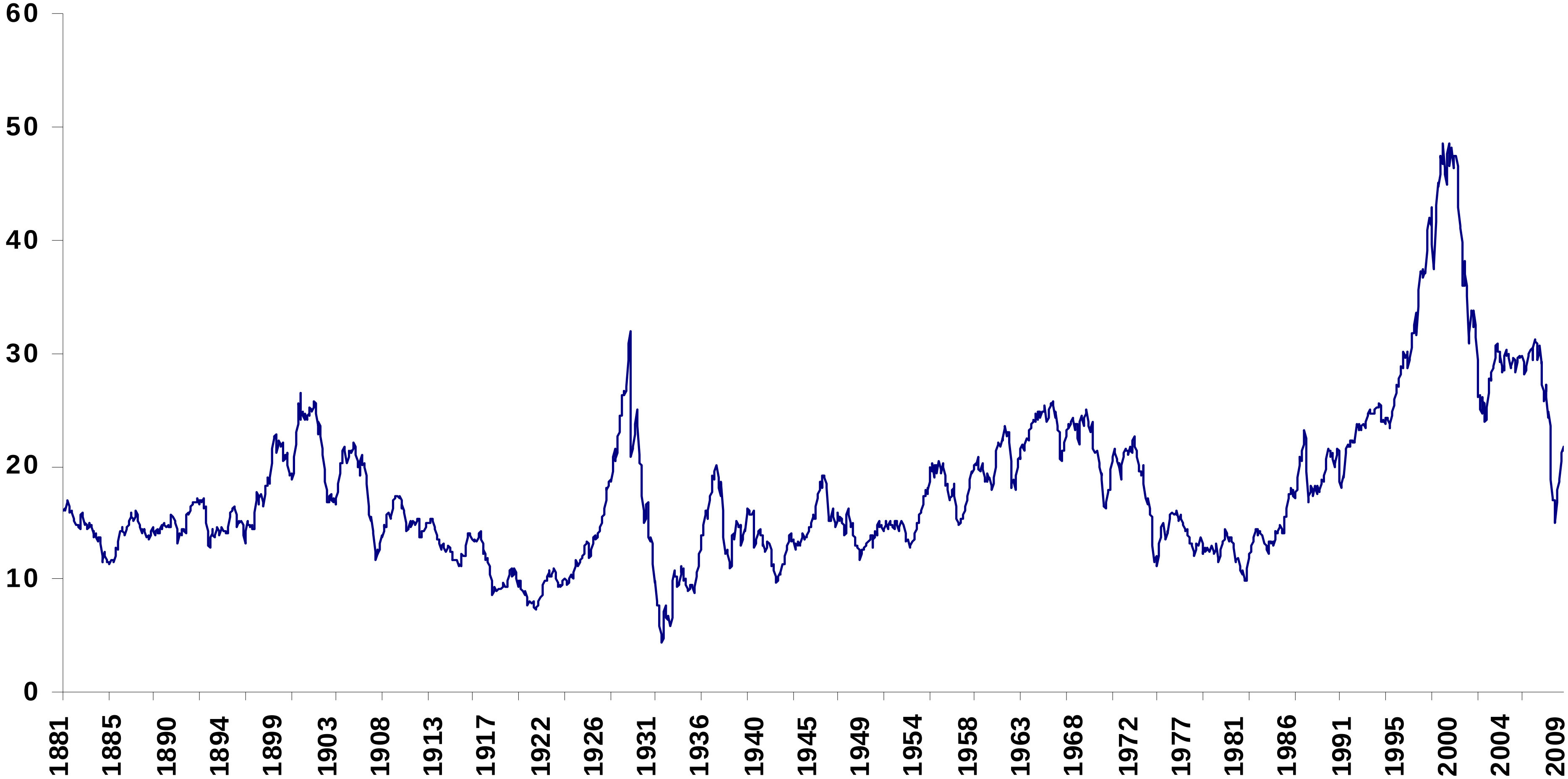
Date of Purchase	% decline from purchase to market trough	Months to market trough	Months before mkt return to purchase level
1917.09	-16	3	18
1931.10	-53	8	21
1942.03	-4	1	3
1982.03	-1	4	6
Average	**-19**	**4**	**12**

US market 1881-2008

	Subsequent Average Return					Worst Subsequent Return					% of times subsequent return positive				
	1 Yr	**2 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**1 Yr**	**2 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**1 Yr**	**2 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
13	21	34	41	67	101	-24	-26	-18	-11	-38	80	92	91	94	92
10	26	37	43	80	93	-24	-11	-72	3	-38	82	92	90	100	95
9	34	41	52	93	82	-16	15	5	18	8	83	100	100	100	100
5	134	112	126	243	87	131	102	125	242	85	100	100	100	100	100

Source: GMO

Graham and Dodd PE (S&P500)



Source: GMO

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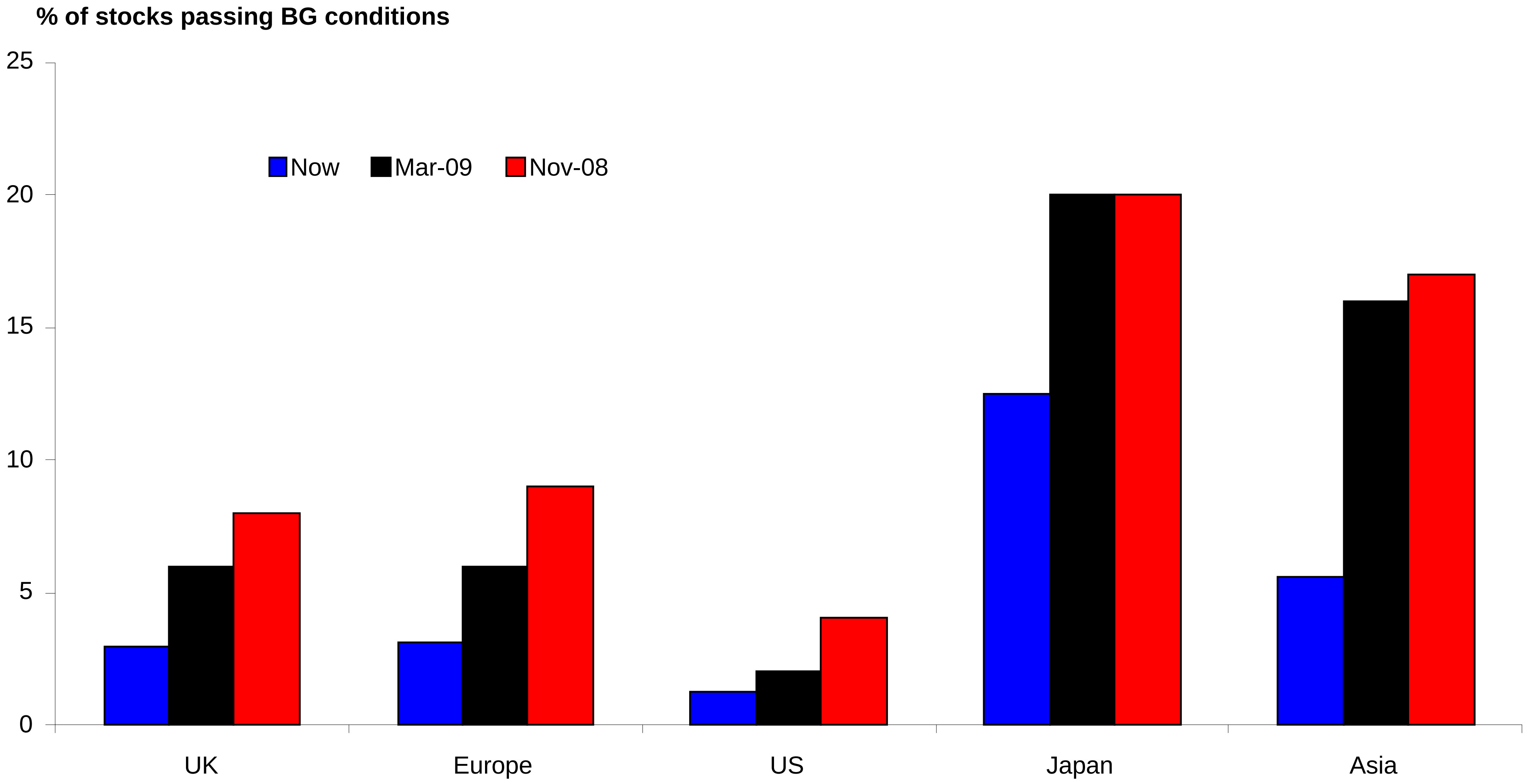
Bottom up valuation: What would Ben think?



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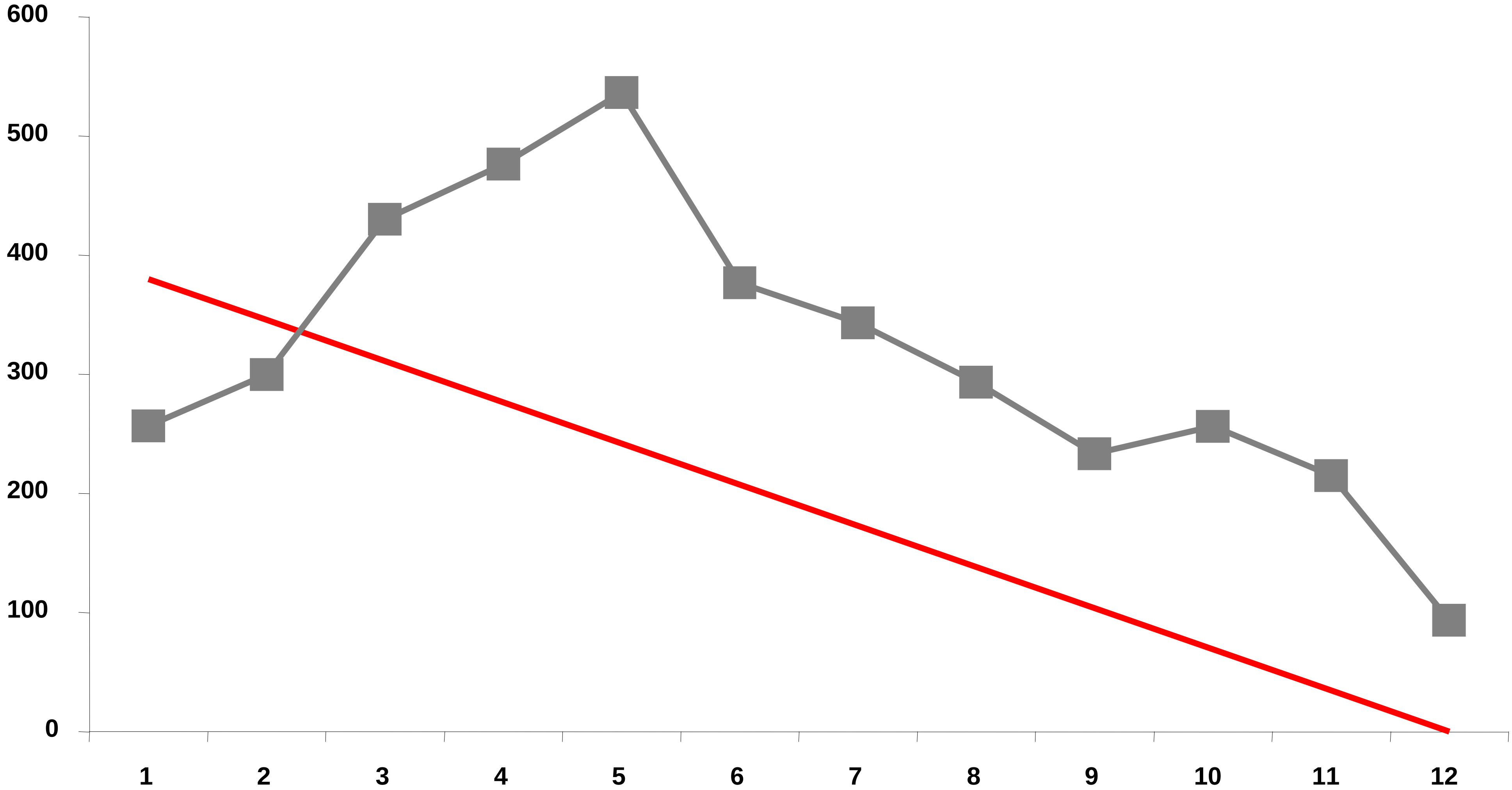
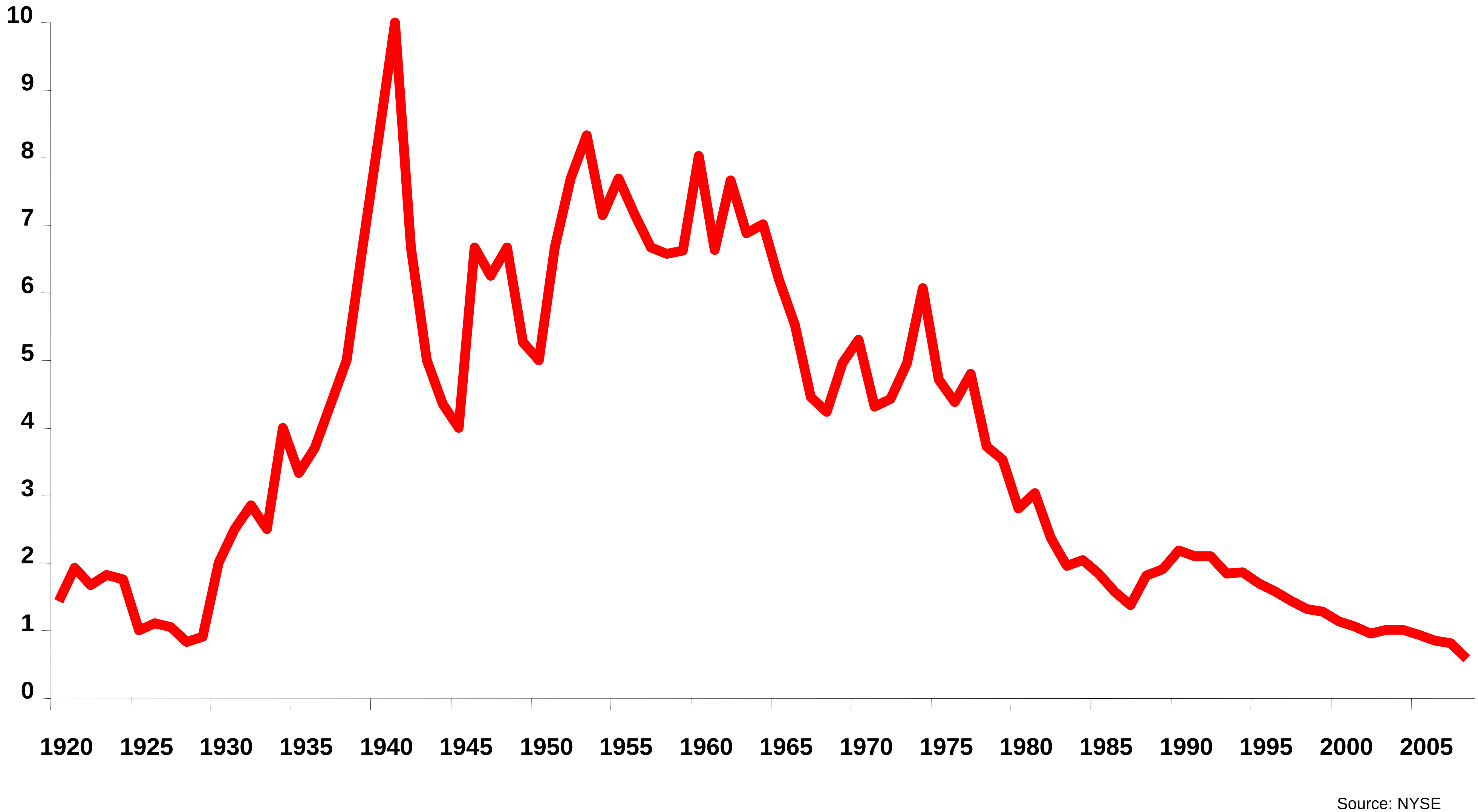
Lesson V: Wait for the “fat pitch”



Source: Plottt et al

ADHD and stock holding periods



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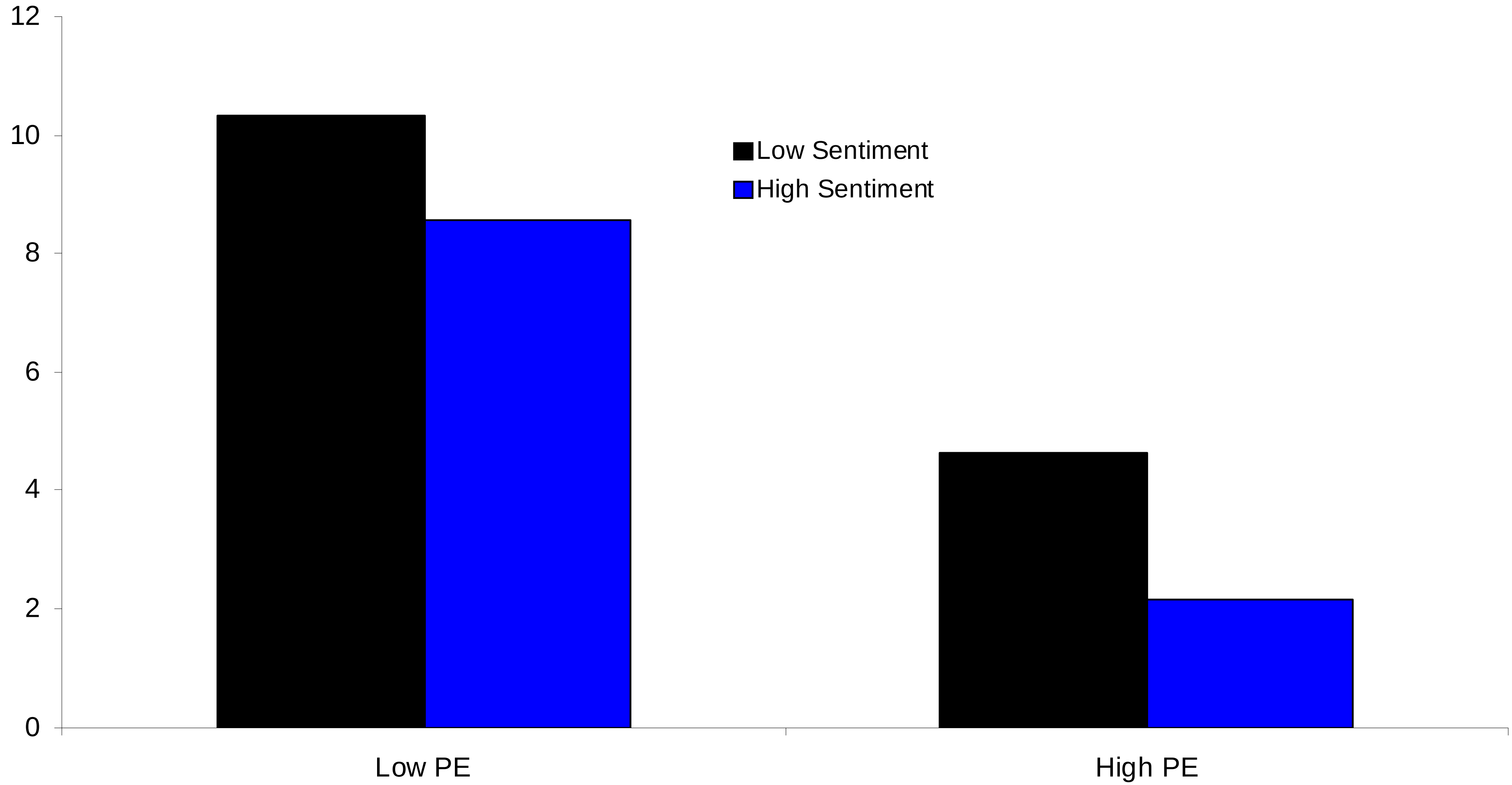
Lesson VI: Sentiment matters



Source: GMO

Exploiting sentiment (US 1962-2000)

Source: Baker and Wurgler

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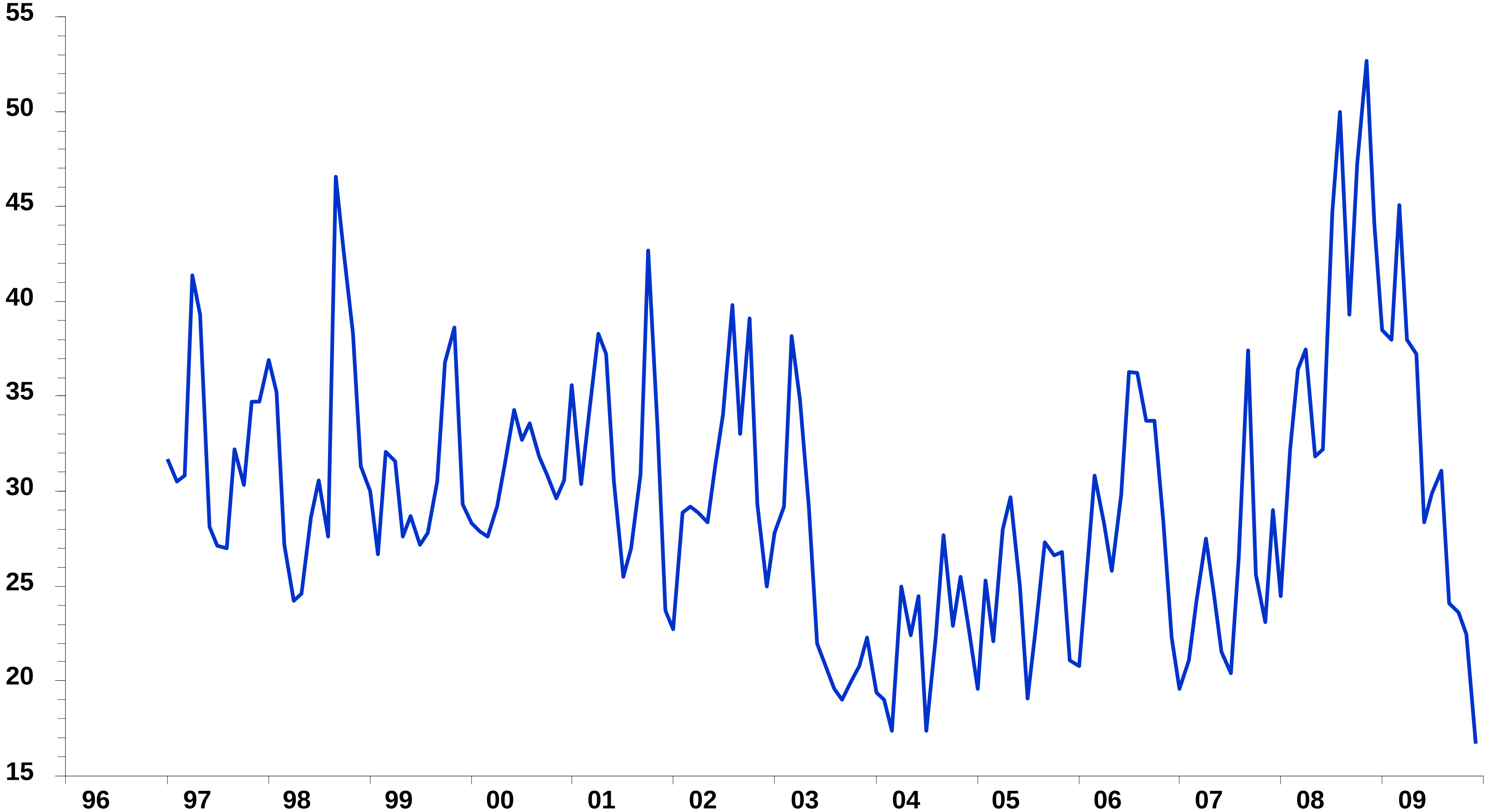
Sentiment suggests need for caution



ADVISORS SENTIMENT BEARISH

Source: DATASTREAM

Lesson VII: Leverage can’t turn a bad investment good

- *Leverage can’t turn a bad investment good, but it can turn a good one bad*
- *Limits staying power*
- *Can turn a temporary impairment (i.e. price volatility) into a permanent impairment of capital*
- *Beware of financial innovation…often just leverage in a thinly veiled disguise*

Lesson VIII: Beware of over-quantification

Ben Graham:

"Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics the more uncertain and speculative are the conclusions we draw there from…Whenever calculus is brought in, or higher algebra, you could take it as a warning that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment."

Keynes:

"With a free hand to choose coefficients and time lag, one can, with enough industry, always cook a formula to fit moderately well a limited range of past facts.

I think it all hocus - but everyone else is greatly impressed, it seems, by such a mess of unintelligible figures."

Munger:

"It seems like higher mathematics with false precision should help you, but it doesn't. They teach that in business schools because, well, they've got to do something!"

There are no points for elegance in the real world.

Risk isn't a number

Risk isn't volatility, it is the permanent impairment of capital

Volatility creates the opportunity.

Keynes again:

"It is largely fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them."

Think about risk as a trinity:

Valuation risk

Business risk

Financing risk

Lesson IX: There is no substitute for skepticism

Santayana:

“Skepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer: there is nobility in preserving it coolly and proudly.”

We are in the rejection game.

Lesson X: Benefits of cheap insurance

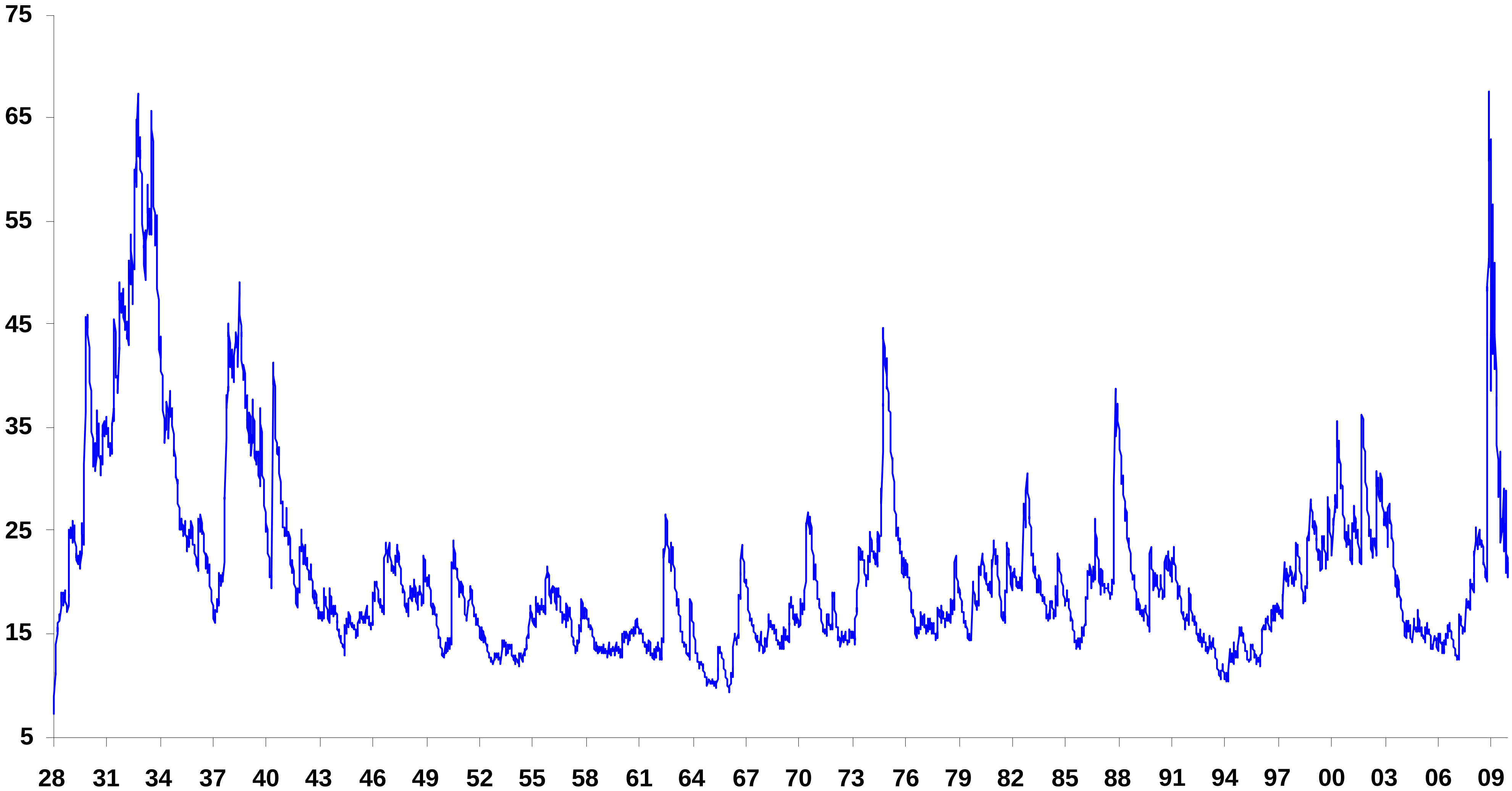
Insurance is often disliked in investing, because of the nature of the cash flows, but that often makes it cheap!

Examples:

Inflation insurance

Moral hazard/market melt up insurance

Long-term volatility



Source: SG, Bloomberg

Lessons (not) learnt

I. *Markets aren't efficient*
II. *Relative performance is a fool's game*
III. *This time is never different*
IV. *Valuation matters*
V. *Wait for the fat pitch*
VI. *Sentiment matters*
VII. *Leverage can't make a bad investment good*
VIII. *Beware of over-quantification*
IX. *There is no substitute for skepticism*
X. *Don't underestimate the use of cheap insurance*

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