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Out of time

"Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes.. It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; - human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll. Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money – a further reason for the higher return from the pastime to a given stock of intelligence and resources. Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

- John Maynard Keynes, 'General Theory of Employment, Interest and Money', 1936.

In the 'bible' of behavioural investing ('Behavioural Investing: a practitioner's guide to applying behavioural finance'), James Montier amongst many other things addresses "just how ridiculous the obsession with the short term actually is". He imagines a universe of 100 fund managers, each with a 3% alpha[1] and 6% tracking error[2]. An alternative way to describe this cohort is as a population of 0.5 information ratio[3] investors. "An information ratio of 0.5 is pretty good. According to Grinold and Kahn (2000) an information ratio of 0.5 would put these investors in or close to the top quartile." See Table 1 below.

So Montier creates a little universe of quite good investors and then hits them with random shocks. Each of these fund managers, we should remember, has a "true alpha" at inception of 3%. Montier allows these managers to run money for 50 theoretical years and tracks their performance over time. The results are instructive.

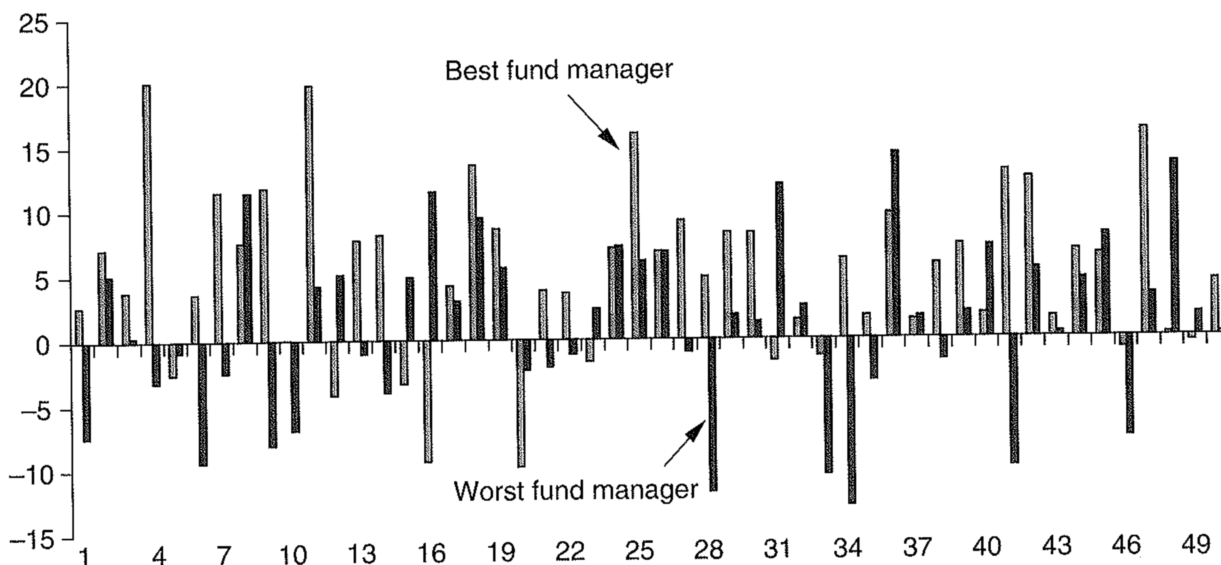
Table 1. US active equity information ratios

	Mutual Funds		Institutional Portfolios	
Percentile	Before Fees	After Fees	Before Fees	After Fees
90	1.33	1.08	1.25	1.01
75	0.78	0.58	0.63	0.48
50	0.32	0.12	-0.01	-0.15
25	-0.08	-0.33	-0.56	-0.72
10	-0.47	-0.72	-1.03	-1.25

Source: Grinold and Kahn (2000) / James Montier.

"In terms of the range of returns the best fund manager displayed an alpha of 5.2%, while the worst showed an alpha of 1%. Figure 2 below demonstrates just how hard it is to tell the 'good' from the 'bad' on the basis of annual returns. However, of more interest to me was the various statistics we collected on underperformance."

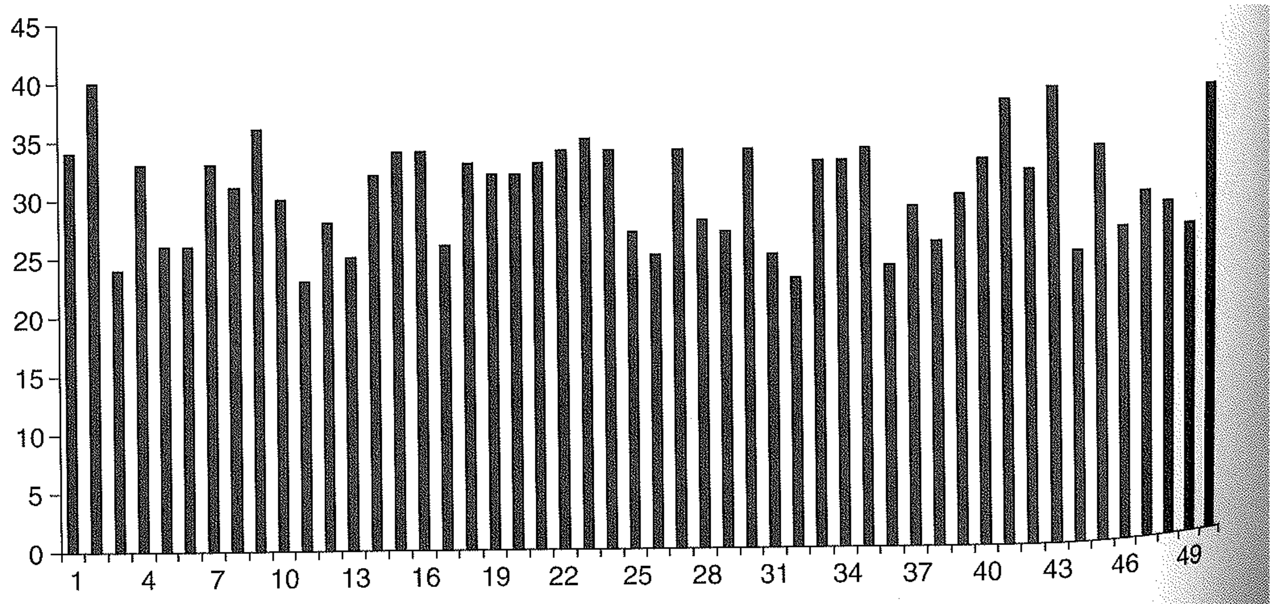
Figure 2. The best and worst fund managers in Montier's universe (% return)



Source: DrKW Macro research

"For instance, when looking at the cross-section, almost one in three of our fund managers underperformed the benchmark each and every year (Figure 3 below)."

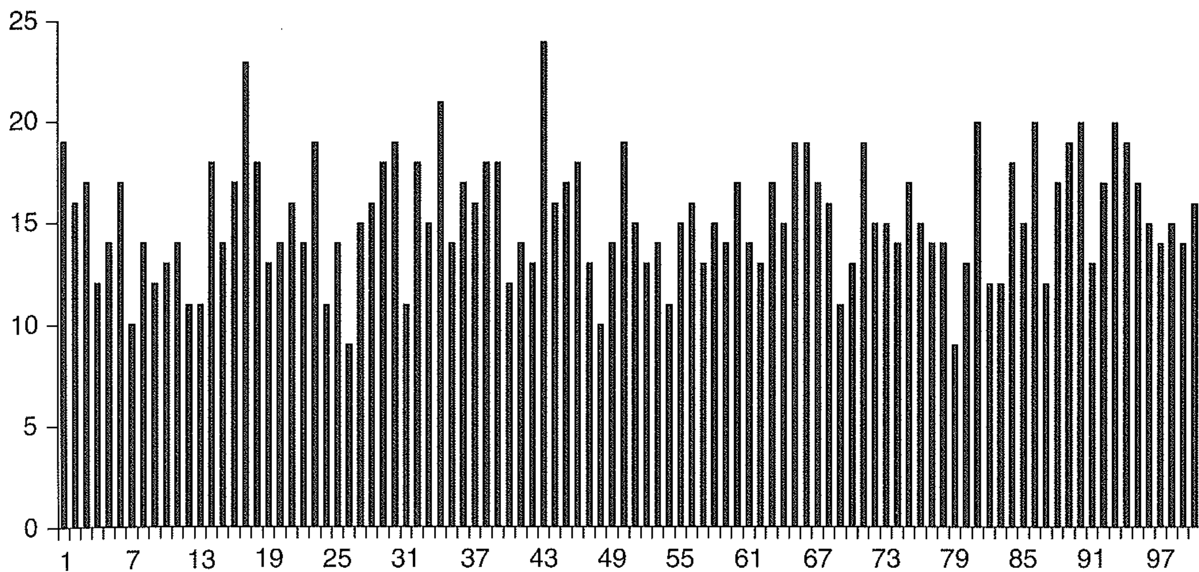
Figure 3. Percentage of Montier's 100 fund managers underperforming each year



Source: DrKW Macro research

"An alternative perspective is given in Figure 4 below. This shows the total number of years in which each of our fund managers encountered a negative return – that is, they underperformed their benchmark. On average, each of our managers spent about 15 years of our 50-year sample underperforming; the minimum was 9 years and the maximum was 24 years !"

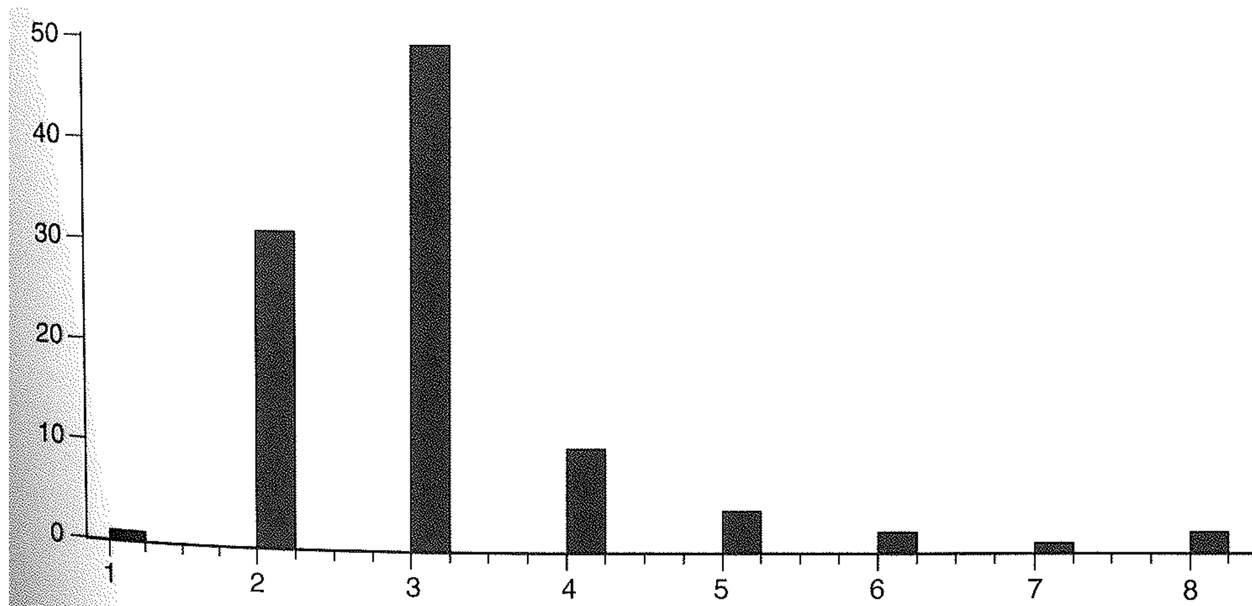
Figure 4. Number of years of underperformance per manager



Source: DrKW Macro research

“Figure 5 below shows the histogram of consecutive years of underperformance. On average, even with an information ratio of 0.5, runs of 3 years of back-to-back underperformance were very normal. Indeed 4 or 5 years of continuous underperformance are far from unheard of.”

Figure 5. Frequency of cumulative years of underperformance



Source: DrKW Macro research

“Remember that each of these managers has 3% alpha by design, yet that doesn’t stop them encountering bouts of up to 8 years of back-to-back underperformance. Despite the fund managers having a high alpha and a high information ratio, it wouldn’t have been enough to prevent almost every one of the fund managers from being fired by their clients at some point over the 50 years of our data run.”

“Of course, when investors are myopic they tend to check their performance frequently. The more frequently they examine their portfolio performance, the more likely they are to encounter a loss. Such myopic behaviour almost becomes self-fulfilling.”

“We need to extend investors’ time horizons, and that means being honest with the ultimate investors about the risk of loss in the short term (very high). It also means encouraging longer holding periods and better-structured contracts between the ultimate investors and their chosen agents. It requires dispelling the illusion of control and the illusion of knowledge such that fund managers admit to the truth that they can’t pick stocks or markets over the short run.”

“It also requires that investors try to stop ‘beating the gun’: instead of focusing on ***speculation*** (Keynes’ term for the activity of forecasting the psychology of the market), we need to refocus our industry on ***enterprise*** (Keynes’ term for the activity of forecasting the prospective yield of assets over their whole life). This in turn means that analysts need to stop obsessing about the next quarterly set of results, and corporate managers can get back to running their business for the benefit of shareholders, rather than pandering to the investment equivalent of those suffering attention deficit hyperactivity disorder (ADHD).”

“Keynes, too, was exasperated by the obsession with short-term performance. He opined:

"*The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only.*"

There are, doubtless, innumerable investors across the world looking at their portfolio statements this month with some disbelief. For stocks, bonds, commodities and gold all to incur the sort of wild swings they have experienced is more than a little unsettling. From our perspective, we adopt a four-factor model that we will continue to use. We allocate to objectively high quality sovereign credits now yielding roughly 5.25% versus US Treasuries (the putative "risk free rate") where the 5 year yield is less than 1.5% even after the gyrations of June. We allocate to defensive and attractively priced listed equities. We allocate to systematic trend-following funds that we consider to be broadly market neutral over the medium term and which we therefore view as bellwether investments. And we allocate to real assets, notably the monetary metals, gold and silver. Not one single news or market event causes us to question our commitment to this approach (which is, in truth, a way of not having to make extreme subjective judgments about the merits of disparate asset classes, or about market timing).

What does seem increasingly clear is that Ben Bernanke and the Federal Reserve have lost control of the markets. Having made the most innocuous of attempts to back-pedal from endless quantitative easing – and having been slapped in the face by the markets for his trouble – Mr Bernanke or his ultimate successor(s) at the Fed will, we may rest assured, continue to print money at the first sign of a market collapse. That is why we hold gold, for example, in the teeth of a violent correction in its notional price in US dollars. If the Fed is destined to maintain monetary stimulus to placate ever more fractious financial markets, it will end up destroying the very confidence (not least in the dollar) that it was endeavouring to bolster.

These are difficult times for explicit value investors – especially when trashy investments experience surges of popularity out of all relation to their inherent risk. If you have a plan that has worked well for decades, it seems churlish to abandon it after incurring some admittedly marked short term volatility. As Warren Buffett has remarked, price is what you pay; value is what you get. We have bought expressions of explicit value across multiple asset markets, and over time we expect its merits to be recognised. How the prices of those investments perform in the short run is out of our control. And that of the Fed, by the look of things.

[1]*Alpha: a measure of risk-adjusted performance. The extent to which a mutual fund outperforms or underperforms its benchmark.*

[2]*Tracking error: the divergence between the price performance of a mutual fund and the price performance of its benchmark.*

[3]*Information ratio: the ratio of portfolio returns above the benchmark to the volatility of those returns.*

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