Dare to be great – the challenge of being different

Dominic McCormick | Select Asset Management | 10 June 2014

Howard Marks at Oaktree Capital Management recently wrote an excellent article - "Dare to be Great" - about the ongoing challenges of managing money and building investment portfolios. Essentially, he makes the simple yet powerful point that "You can't take the same actions as everyone else and expect to outperform". Or, put another way, "Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to being both".

Therefore, while being different provides no certainty of great results (as it increases the chances of being wrong as well as right), it is a necessary but not sufficient ingredient to producing great performance. Many other elements - skill, insight, access, luck - also come into the equation.

Of course, some investors and advisers don't want or need to outperform or produce great results. Perhaps, they just want to achieve around "average" performance. (Abstracting from the problem of defining what average performance actually is). But how should they achieve this? At first glance, you might suggest that all you need to do is see what the crowd is doing and follow it. Unfortunately, in practice, this will not result in average performance. Instead, it will result in well below average performance. By "following" the crowd, you are not really investing "with" the crowd but, instead, you will typically become overexposed to and overpay for popular investments that the crowd has already pushed up in price while selling assets that have already moved out of favour and down in price.

Indeed, the two elements that seem ingrained into most crowd-following investors are the tendency to:
1. Exit or decrease recently poorly performing/out of favour asset classes/sectors or managers; and,
2. Add or increase recently best performing or hot asset classes/sectors or managers.

Given this, while there may be no sure recipe for outperformance, it is clear that following those two "guidelines" is a sure way to guarantee underperformance or poor results.

Of course, following the crowd will not always prove to be the wrong decision. A few investment managers can demonstrate good performance over very extended periods. Some sectors and asset classes can occasionally experience multi-year secular bull markets that go much further and longer than many expect (albeit typically ending in a bubble and bust). Conversely, some poorly performing managers continue to perform poorly for specific reasons and some asset classes or at least sectors can face such dramatically changed fundamentals that they never recover properly. (The impact of the Internet on some

industries is an example of this.)

However, the above paths are the exceptions. The cases where blindly following the crowd into and out of popular investments results in losses or poor returns is the more normal course of events. While going with the crowd can feel good for much of the ride, it will likely subtract value more often than not. Importantly, some of the largest, more permanent losses come from chasing what is hot because an investment's full potential (plus more) is, by then, usually more than fully priced in (and, also, because investors are then reluctant to take risk again after a particularly bad experience).

Outperforming, or even just avoiding chasing markets, needs an unconventional or contrarian approach. Again from Marks: "Unconventional behaviour is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes".

I was recently talking to a value fund manager about the need to be contrarian as a way to add value, despite how difficult this can be and the lack of reward for taking contrarian opportunities in the current environment (although I don't expect this to be permanent). His response was "Surely, contrarian investing is the only way to outperform, isn't it?". I'm not sure this is entirely the case – some short-term momentum strategies can work, although perhaps this is more speculation than investment. In any case, I do believe that contrarianism is the essence of most successful investment strategies.

However, contrarian investing is inherently difficult, partly because of the behavioural challenge of convincing yourself that zigging while most others are zagging makes sense but, also, because you have to convince your clients/investors to come along. This is where it can go wrong, as investors sometimes do not have the patience to tolerate the months or years for contrarian calls to come good (and not all calls will come good either).

Perhaps many investors should just go passive and forget about either an active contrarian approach or the crowd following approach, given the difficulties of implementing the first and the poor results almost certain from the latter.

The problem today is that even passive stockpicking comes in many flavours such that many decisions are still necessary. For example, do you use capitalisation-weighted indices, an indexed-enhanced approach, equal-weighted indices, fundamental indices, factor-weighted indices, etc? Further, even a passive stock selection approach can still go wrong because of bad asset allocation/sector decisions. Essentially, investors must also avoid the mistakes discussed above in respect of asset classes and sectors, not just managers or stocks. There are two ways to approach this:

1. Disciplined Dynamic Asset Allocation – by no means easy, particularly in the current environment, DAA is an attempt to introduce a contrarian/risk reducing approach to asset allocation. That is, the aim is to reduce exposure as asset classes become expensive and increase exposure as they become cheap, an approach which

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should add value from an increased return or decreased risk perspective (or both) over time.

2. Disciplined Passive Asset Allocation - the rationale for the initial asset mix must be properly developed (there is no escaping some active decisions here) and the mix reviewed at various points over time. Note, I refer to "Passive" rather than “Strategic” asset allocation, as the concept of SAA usually neglects the key role of an asset's starting valuation in driving long-term returns and leads to excessive confidence in the ability to meet investment objectives that is not possible with SAA's inherent "set and forget" framework.

The point is that even a "passive" approach to investing requires employing some of the lessons that Howard Marks highlights, such as being prepared to rebalance and effectively sell out of strongly performing assets and buy into poorly performing assets, even to maintain a passive asset allocation. Even this element of contrarianism requires discipline and a process around the appropriate timing of moves. Such investors are benefiting from the mean reversion effects that the crowd-following investors are creating.

A problem with regard to retail investors however, is that they often seem to have relative (i.e. index) performance benchmarks when markets are rising and absolute (cash-like) benchmarks when markets are falling. Thus, while equal or slight underperformance in good markets and even underperformance over the long term is tolerated, it is harder to get away with poor (or even in line) performance in down markets given the absolute (cash or CPI-plus) objectives and capital preservation focus of many retail clients. You could consider the use of low cost index/passive investments plus tail hedges/insurance protection but this likely guarantees long-term underperformance given the ongoing cost of the insurance.

The key problem is that that the pressures and constraints around building portfolios push even smart and well-meaning investment professionals towards conventional, crowd-following portfolios that can struggle to perform well over the long term (and are at risk of significant underperformance) because of:

- The high costs of active funds (many of which are hugging indices);
- Transaction costs arising from the temptation to churn the portfolio (after all the Investment Committee needs to be seen to be doing something);
- The tendency to move to those managers/assets that have performed well in recent times even though such investments are often heading to a period of sub-par performance;
- Compounding this is a tendency to throw out poorly performing managers/assets - locking in underperformance - often at the wrong time and when a more objective view might suggest they may still have good long-term upside and/or diversification benefits;

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- A lack of proactive and timely dynamic asset allocation moves given the challenges of developing, convincing relevant parties and then actually implementing such views. Even with a passive asset allocation approach, there is often reluctance to cur/rebalance strongly performing areas or add to re-balance poorly performing areas; and,
- An unwillingness to use more complex or costly strategies that may have good potential or diversification benefits (for example, some higher cost managers/hedge funds/options).

Perhaps, in practice, relatively few investors are well placed to take the big contrarian calls that are essential (but not sufficient) to achieve great results. Fewer still can recruit enough patient and disciplined investors to come along for the difficult ride that this sometimes entails.

However, I do think that the less ambitious task of avoiding doing the wrong thing is something that can be implemented by most investors with a little more discipline. Again, this may not guarantee great results but it does dramatically reduce the risk of very poor results, especially in absolute terms.

The important point is to have a strong sense of your investment philosophy and the limitations of implementing this. If your investment philosophy lacks a commitment to words like value driven, contrarian and ignoring benchmarks and the required disciplined process to implement these in practice, perhaps you should be more passive. Even then, some will underestimate the discipline and willingness to think contrarian that even such a passive approach needs at times.

Importantly, examining and determining where one lies on this spectrum between the "full on" active contrarian investor and the passive "part" contrarian investor should help to avoid ending up in the other camp that is the sure road to poor long term performance - that is, the crowd following/performance chasing game. As someone once said about the stockmarket: "If you don't know yourself then this is an expensive place to find out."

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