PRICE**VALUE**PARTNERS

The proof

"CreditEase, one of China's biggest peer-to-peer lenders, has set itself a Herculean task for the next 10 years: taming the country's notoriously volatile retail investors by introducing them to the idea of portfolio management.

The typical household's approach to wealth management was "to throw investment opportunities together, so your overall portfolio structure is all over the shop", said Tang Ning, chief executive."

- 'Robo-advisers look to tame China's retail investors' by Yuan Yang, *The Financial Times*, 30 January 2017.

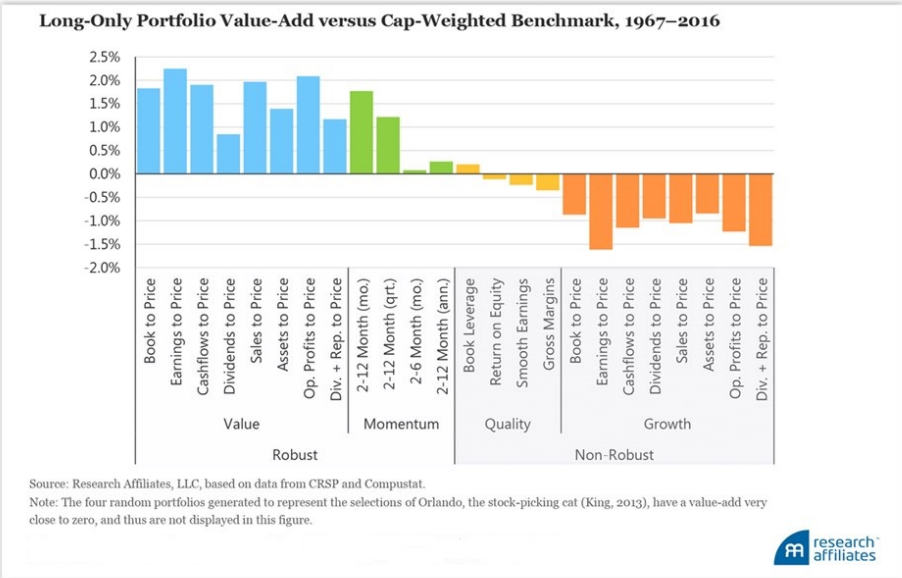
Successful investing involves having an edge. If you do not know what your edge is, you do not have one. Tang Ning's observation above rings true; there are doubtless many investors who, in the absence of a general strategy, have accumulated a portfolio of sorts more or less randomly on the back of colliding haphazardly over time with motley financial opportunities, some of which have somehow appealed. The financial media clearly play a role in bombarding their users with arbitrary investment stimuli.

Robo-advice may be an improvement on random investing, but it seems to solve one problem (the presumed high cost of investment provision) by creating another (passive investing guarantees mediocre returns, or the market average return, less the cost of fees).

But there is another, more insidious, problem with passive investing, exemplified by the looming flotation of the owner of Snapchat. Snap's IPO offers the hardly alluring prospect of a share class with no voting rights at all. Individual investors are of course welcome to pour their money down whichever drains they choose. But the rise of low cost ETFs – alongside the already substantial numbers of index-trackers, explicit or otherwise – means that there will be plenty of institutional investors obliged to follow them; the *Financial Times* cites Anne Sheehan, the head of corporate governance at Calstrs, the California teachers' pension fund, who points out that many benchmark-following funds will be forced to own Snap once it is included in stock market indices, whether they want to or not. Come to ETFs for the focus on low cost; stay for the guarantee of exposure to low quality assets.

Active management requires doing something different from the herd. One way in which managers can differentiate themselves is by focusing on what actually works. In a fascinating study by Research Affiliates, a 49 year study of performance highlights the best and worst performing strategies over the longer term for equity investing.

The best performing strategies, compared to a market capitalisation-weighted benchmark, were value, and then momentum, as shown in the graph below. (Favouring low p/e stocks seems to have been the single best factor.) Three of four 'quality' filters ended up detracting from performance – as did every single 'growth' filter. Research Affiliates concluded that 'quality' and 'growth' strategies were "non-robust".

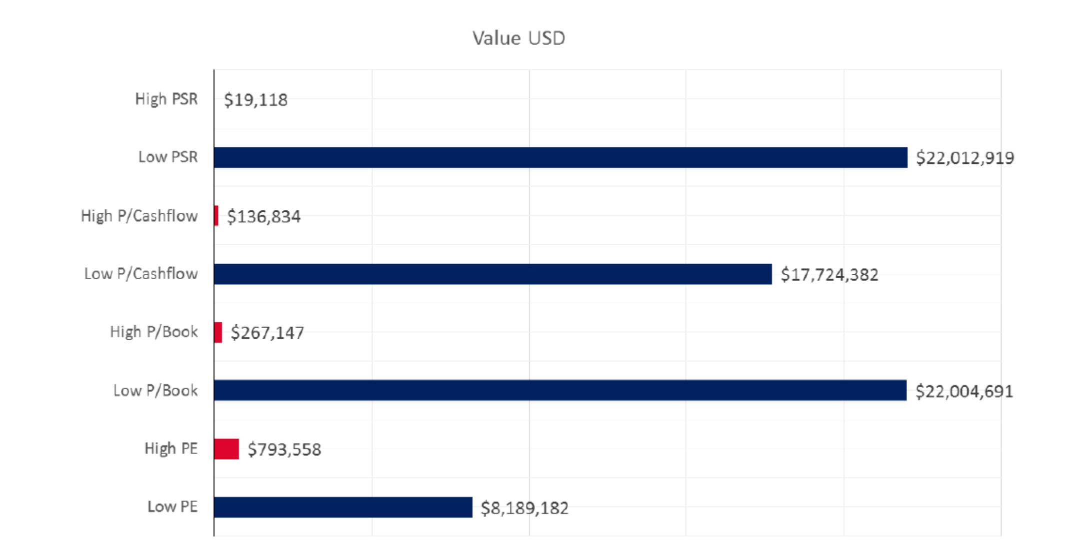


Long-Only Portfolio Value-Add versus Cap-Weighted Benchmark, 1967–2016

Source: Research Affiliates, LLC, based on data from CRSP and Compustat.
Note: The four random portfolios generated to represent the selections of Orlando, the stock-picking cat (King, 2013), have a value-add very close to zero, and thus are not displayed in this figure.

These findings are consistent with a similar study conducted by James O'Shaughnessy in his book 'What works on Wall Street', the results of which are shown below.

Value of $10,000 invested in various strategies for the 52 years ending in December 2003



Source: What Works on Wall Street by James P. O'Shaughnessy

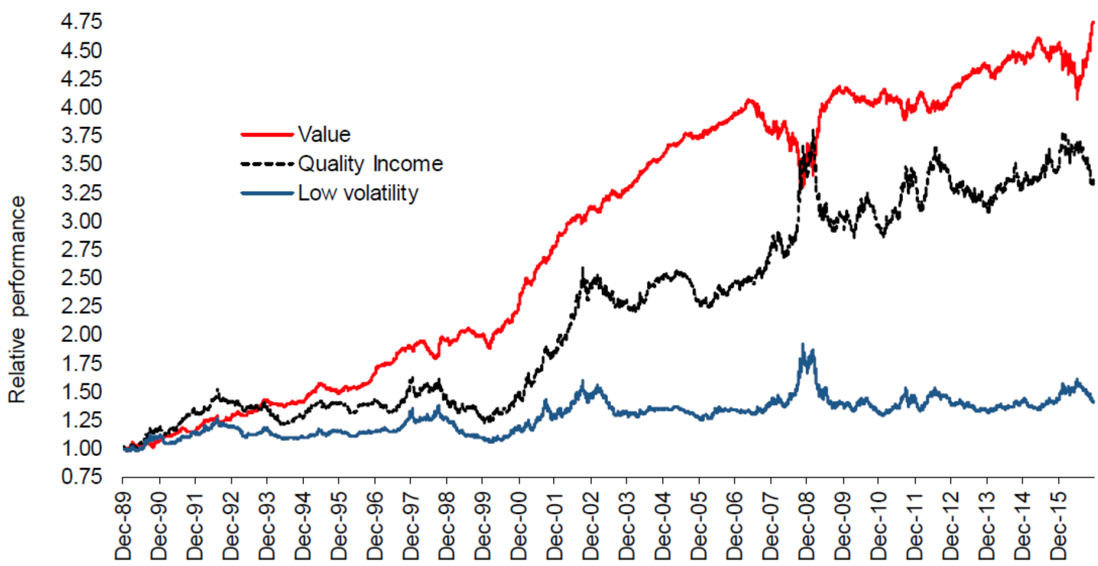
O'Shaughnessy selected the 50 stocks from the broad market with the most extreme 'value' characteristics (low price / book, low price / earnings, etc.) and the 50 stocks with the most extreme 'growth' characteristics (high price / book, high price / earnings, etc.) and then rebalanced each portfolio annually to ensure that only the 50 most extreme stocks were held over a period totalling 52 years.

A portfolio with a starting value of $10,000 invested in 'growth' stocks – as assessed by high price / book, for example – ended up, after 52 years, being worth $267,147. Which sounds like a good deal, until you appreciate how much a 'value' portfolio (by price / book) would have appreciated – in this case, being ultimately worth over $22 million.

The results of both of these studies are confirmed by SocGen in their analysis of the best performing strategies over the last quarter century, as shown below. Versus either 'quality income' or 'low volatility' approaches, 'value' beat both.

IN THE LONG RUN VALUE INVESTING IS WHAT MATTERS

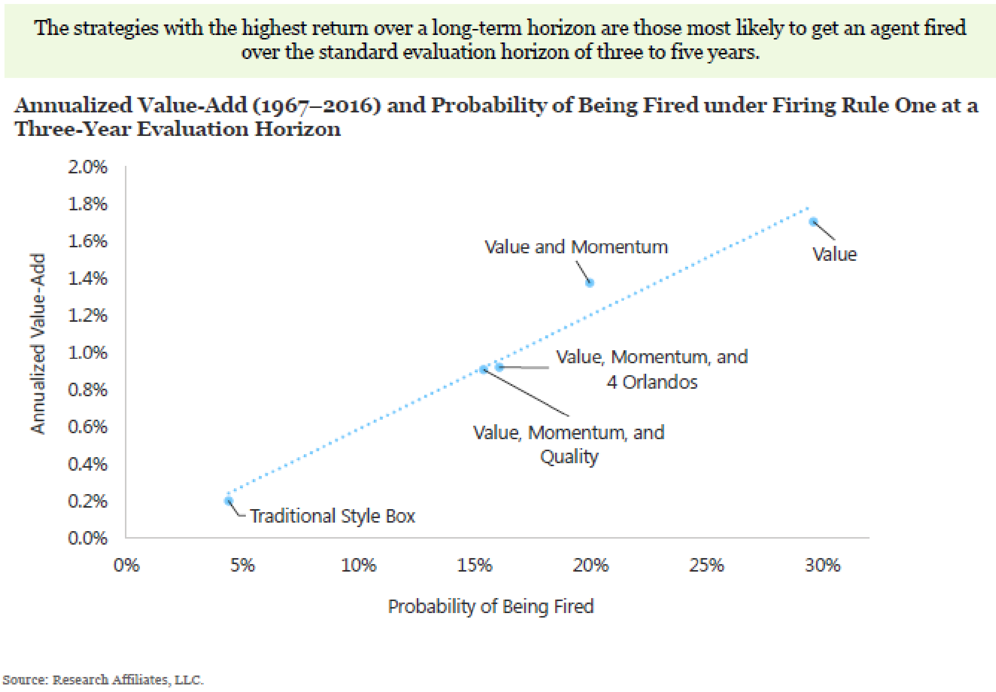
Relative performance of a global Value, Quality Income and Low Volatility Portfolio



Source: SG Cross Asset Research/Equity Quant, FTSE, I/B/E/S, FactSet

Given the data, why would investors favour any other approach ?

Research Affiliates point to an intriguing answer: because investors, or their managers, lack the discipline, or the patience, to stay the course. Although a 'value' approach is statistically the most likely to generate the highest investment returns over the long run, it is also the strategy most likely to get a manager fired for short term underperformance:



Research Affiliates' 'Firing Rule One' amounts to firing the fund manager 'agent' if more than 50% of the funds he or she selects underperform their benchmark in a given period.

This would seem to provide yet another reason to be wary of benchmarks – namely, that they encourage short term behaviour on the part of fund managers, or clients' advisers, that is ***actively injurious*** to their clients' longer term interests.

In investment, there is a crucial difference between want and need. What many investors want, as behavioural economists have conclusively shown, is an investment approach that generates the least discomfort from the prospect or delivery of capital loss in the short term. What most investors actually need is an investment approach that both maximises their returns and minimises the prospect of permanent capital loss over the longer term. What they need, in other words, is value investing. There is no shortage of proof. The difficulty is the inevitable pain that comes with marking to market in the short term. As the financial journalist Jonathan Davis observes,

"Periods of excruciating short-term underperformance are a burden that all genuine value investors have to endure."

But the long term returns are worth it.

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