PRICE VALUE PARTNERS

J'accuse

"The entire investment industry is centred around making the numbers go up. Not in a bad way – just the way medicine was 50 years ago, when it viewed the noble mission of the profession as knocking out disease, full stop. The investment philosophy is a cousin of the same well-meaning but wrong ethos medicine used to have:

- Everyone wants to make money.
- There is a right and universal way to make it.

You see this in investment commentary.

"What should investors do now?"

"What's the best trade?"

"Why it's time to get out now."

"Half of this stuff is drivel. But even the smart stuff rarely acknowledges who the advice is useful for. And we rarely recognize that most investment debates – debates that literally make markets – are just a reflection of people making different decisions not because they disagree with each other, but because they view investing with a different set of priorities."

- *How to talk to people about money*, by Morgan Housel, 29 March 2018.

The name Daniel Bernoulli is not as celebrated in investment circles as it probably should be. A true 'Renaissance Man', Bernoulli was an 18th Century Swiss mathematician who was also, in the words of the Victorian statistician Francis Galton, "physician, botanist, and anatomist, writer on hydrodynamics; very precocious". He also has a good claim to be one of the world's first behavioural economists. Bernoulli's (investment) thesis was that people ascribe different values to risk; crucially, we are not all the same. He then went on to observe, as Peter L. Bernstein tells us in his magisterial *Against the Gods: the remarkable story of risk*, that

> The utility resulting from any small increase in wealth will be inversely proportionate to the quantity of goods previously possessed.

The dry language, to a 21st Century mind, might camouflage some of the importance of Bernoulli's conclusion. In plain English, his argument was that the more wealth one possessed, the less meaningful any material gain in the value of one's portfolio. To put it another way, when managing money for the wealthy, ***just don't lose it***. To those who have spent a lifetime accumulating a fortune, what matters is keeping it, not doubling it (for example) – if the likelihood of generating a sizeable gain comes with an attendant possibility of demolishing the initial pot of savings instead. We could even argue that this philosophy is not limited to the wealthy alone – however arbitrarily we define wealth. One can make a plausible case that it should really apply to almost everybody, whatever the size of that 'initial pot'. As we now know from the behavioural economists, human beings are loss averse. We have a natural tendency to bank profits too soon, lest they turn into losses; and because crystallising a loss is painful, we tend to hang on to loss-making positions for far too long, often exacerbating the ultimate pain.

Morgan Housel's excellent piece, cited and partially quoted above, reminds us that we are all different. Investing means different things to different people:

> People who work in finance underestimate that watching markets go up and down isn't intellectually stimulating for most regular people. It's a burden. And even if they can technically stomach investment risk, the added complexity robs bandwidth from other stuff they'd rather be doing. The opposite is true. Claiming your investment product is entertaining is usually the refuge of those who can't point to performance. But it's crazy to assume that many people don't find investing incredibly entertaining – so much so that they rationally do nutty stuff regardless of what it does to their returns.
>
> Everyone giving investing advice – or even just sharing investing opinions – should keep top of mind how emotional money is and how different people are. If the appropriate path of cancer treatments isn't universal.. don't pretend like your bond strategy is appropriate for everyone, even when it aligns with their time horizon and net worth.
>
> The best way to talk to people about money is keeping the phrases, "What do you want to do?" or "Whatever works for you," loaded and ready to fire. You can explain to other people the history of what works and what hasn't while acknowledging their preference to sleep well at night over your definition of "winning."

This is problematic, to say the least, for the larger providers of financial advice and 'wealth management' today, in that, in the cause of cost 'efficiency' and managing that rising regulatory tide, conventional industry practice now obliges most practitioners to shunt their clients into arbitrary risk-graded silos or model portfolios, predicated almost exclusively on quantitative (and backwards-looking) financial analysis. Bonds are deemed low risk (at their most expensive levels in recorded history). Home country bias in equities is practically obligatory. Anything that has the whiff of the unusual, the esoteric, the road less travelled, the less-than-entirely-liquid, let alone the unregulated, must be treated as if deadly poison.

The Prussian military commander Helmuth van Moltke coined a phrase apposite for any investment adviser and their client: no battle plan survives first contact with the enemy. Even making the generous presumption that our hypothetical adviser can – in the light of the deadening and highly restrictive environment in which he or she may be obliged to work – indeed construct an appropriately diversified bespoke portfolio that matches the needs and aspirations of their client, they will still be faced, inevitably, with the psychic pounding that comes, noisily, with the arrival of any bear market. At this point, all claimed investment horizons will shrink to a matter of hours, beneath a battery of increasingly shrieking newsflow from the more ghoulish members of the commentariat. The rush into cash and 'safe havens' begins..

One of the more trenchant criticisms of the fund management industry was penned in 'The Financial Analysts Journal' of July / August 1975 by veteran investor Charles D. Ellis, the founder of Greenwich Associates, in an essay entitled 'The Loser's Game':

> The investment management business (it should be a profession but it is not) is built upon a simple and basic belief: Professional money managers can beat the market. That premise appears to be false.. The belief that active managers can beat the market is based on two assumptions: (1) liquidity offered in the stock market is an advantage, and (2) institutional investing is a Winner's Game.. The unhappy thesis of this article can be briefly stated: Owing to important changes in (recent) years, these basic assumptions are no longer true. On the contrary, market liquidity is a ***liability*** rather than an ***asset***, and institutional investors will, over the long term, ***under***perform the market because money management has become a Loser's Game.

Ellis goes on to amplify what he means by a Winner's, as opposed to a Loser's, Game. Tennis played by professionals is an example of a Winner's Game. Victory is due to winning more points than your opponent wins: not simply to getting a higher score, but getting that higher score by winning points. The amateur tennis player, on the other hand, invariably scuffing the ball into the net or serving double faults, seldom beats his opponent, but often beats himself.

Institutional investing was at one stage a Winner's but became a Loser's Game with the passage of time, not to mention the inflow of thousands of new participants, some even with talent. As Ellis points out,

> Competitively active institutional investing has resulted in sharply higher portfolio turnover.. how can institutional investors hope to outperform the market.. when, in effect, they ***are*** the market today ?

The outcome, we now know, was clear. First, the rise of indexation (of which the exchange-traded fund is an intriguing and generally useful more recent variation). Next, the rise of so-called alternative asset managers who eschewed benchmarking with the aspiration of generating pure absolute returns. These twin trends succeeded in polarising the investment industry: the former was and remains the low cost (beta) option; the latter, the nominally high cost but putatively higher alpha alternative. (As for 'high cost' – please see 'net returns'.) Which made life doubly difficult for the closet-trackers in the middle, resolutely hugging the benchmark, plus or minus a percentage point or two, but charging active fees and thus dooming their unit holders to underperformance. All, that is, except for John Bogle, whose Vanguard Group remains the only legitimately ***mutual*** fund business (making unitholders part owners) in the US.

But the increasing trend towards 'professionalism' (certainly, 'overcrowding') in asset management has not killed off traditional asset management entirely. Rather, just as Ellis first indicated, long-only managers, for example, should probably focus on simplicity, concentration, and economy of time and effort. If other traditional managers are turning over their portfolios like the tub of a washing machine, there is a high likelihood that fortune will favour the more patient mind. This may be doubly true given the (relatively short-termist) involvement of so many alternative managers on the short-side: 'time horizon arbitrage' may come to benefit the value investor with strong convictions, concentrated holdings and no real urgency to book a profit. Or in Ellis' words:

> Why not bring turnover down as a deliberate, conscientious practice ? Make fewer and perhaps better investment decisions. Simplify the professional investment management problem. Try to do a few things unusually well.

Unfortunately, somewhere along the way, Ellis' message got hopelessly garbled. The financial advisory and 'wealth management' industry seems, in some cases, to have become utterly detached from any commitment to offering the sort of bespoke investment services that might warrant higher fees versus lower cost, passive solutions. Worse still, the industry now seems, in some cases, to be trying simply to do a few things, and unusually badly.

www.pricevaluepartners.com @timfprice

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.