

Strategy Thoughts

August 2014

Discipline!

Introduction

Last month I included in my concluding remarks with the following;

I continue to believe that preservation of capital will be the most important investment goal, not chasing further gains or higher yields, for most investors over the coming months.

This very much continues to summarise my views. Over the last month we have seen a hint of the danger of chasing yields with the Barclays high yield bond ETF having fallen 4% on fairly heavy volume wiping out half of its gains of the last twelve months. At the same time most equity markets have also slipped with some small cap indices down 10% for the month and the US dollar has continued to strengthen slightly. Whether these one month moves mark the end of the cyclical bull market in stocks only time will tell but they do highlight some of the risks that are out there and how quickly things can change.

In this month's Strategy Thoughts I provide further perspective on the absolute necessity of discipline when it comes to investing, review some of the investing rules of investment greats past and present that can help provide that discipline and then provide some insights that should assist readers to tie some of these rules together and build a simple, disciplined and workable investment approach.

Why discipline?

Last month I spoke at a conference where the question posed was; successful investment models, art or science? (Readers can review my prepared remarks for this debate at the end of this month's Strategy Thoughts) Over the last couple of months in Strategy Thoughts, partly in preparation for this debate, I have attempted to outline just what it is that I believe drives markets and should therefore be recognised and incorporated in any investment decision making process. Readers will therefore not be surprised to learn that in the debate I came firmly down on the side that successful investing is far more of an art than a science. I was not surprised, nor was the contrarian in me disappointed, when the majority of the audience preferred to view successful investment models as being more science than art.

I can easily understand why an audience of financial advisers would want the answer to the constant conundrum of investing to be a science; it provides both them and their potential clients with a degree of comfort, unfortunately that comfort is totally misplaced.

Wikipedia defines science as;

‘A systematic enterprise that builds and organises knowledge in the form of testable explanations and predictions about the universe.

In science when a testable prediction fails it means that the theory that drove that prediction is wrong and that a new theory is required. This has clearly not been the case in the ‘science’ of investment models. Investment models based upon theories such as the efficient market hypothesis and the capital asset pricing model that have then been utilised to produce mathematically neat efficient frontiers and Monte Carlo simulated portfolios may have provided a degree of comfort over the last fourteen years

but in the main have severely disappointed investors and never come close to delivering the sorts of returns that seemed almost ‘scientifically’ assured prior to the ‘dotcom crash’ and then the ‘Global Financial Crisis’.

Supposedly scientific models may have let investors down, however, the last five years of reprieve in equity markets seems to have allowed the memories of the ‘science’s’ failure to be all but forgotten by the majority. This is of major concern to me.

I do understand the lure of something scientific and measurable but that in no way means that such a thing is available. However, the fact that successful investing may be far more of an art than a science in no way means that success in investing comes about as a result of random luck. There is certainly an element of luck in all investment success, however, successful investors all share three characteristics; patience, humility and discipline.

Patience is obviously required because in investing gratification is never instant; humility is required largely because of the non-scientific nature of investing, if it were a science then the best practitioners would all make correct forecasts almost all of the time. This is not the case and the ability to accept that a decision may have been ill-conceived or just wrong and to move on is something that all great investors have shared. Finally, and perhaps most importantly, all great investors have been highly disciplined.

As I thought about those characteristics, and particularly discipline, I realised that great investors followed highly structured routes to their success. Naturally there are many different routes, all successful investors do not approach the conundrum of investing in the same way, but they do all follow organised sets of rules. Rules they have learnt through experience over many years and many market cycles, and many of them have done future investors the service of documenting their rules. No one investor’s rules guarantees success, they are not perfectly repeatable rules like the laws of physics, but they do provide a framework that, if practiced in a disciplined manner, allow for the other characteristics of patience and humility to be brought to bear.

Over the years I have often referred to the rules outlined by Max Gunther in ‘The Zurich Axioms’. Followed in a diligent and disciplined manner these will ensure long term investment success, but there are many other sets of rules that have been articulated by equally great investors and analysts and in this month’s Strategy Thoughts I will refer to many of them as I attempt to outline those rules that I believe can deliver long term investment success. Not in a scientific way but in a disciplined, patient and humble way.

Models and rules may appear to offer a scientific solution but all they do, if adhered to carefully, is provide a level of discipline that the majority of investors lack.

Wrong!

A few years ago I read David Freedman’s book ‘Wrong. Why experts keep failing us – and how to know when not to trust them’. The book was published in 2010 and so, along with his criticism of medical studies, health experts and scientists, he had plenty to say about the actions and observations of many ahead of the GFC. Towards the end of the book Freedman lists characteristics of expert advice we should IGNORE;

- It’s mildly resonant, that is it fits comfortably with what we think and may want to hear.

- It's provocative. We like hearing a conventional view is wrong, they often are but we should look for good evidence before abandoning the conventional.
- It gets lots of positive attention.
- Other 'experts' embrace it. More trustworthy advice gathers support over time rather than becoming a bandwagon that everyone wants to board.
- It appears in a prestigious journal.
- It is supported by a big, rigorous study.
- The experts backing it boast impressive credentials.

Not all of these observations can be applied to 'expert' financial and investment commentary but those that can tend to highlight the traps we frequently fall in to as a result of the many behavioural biases we all share. I may have recommended 'Wrong' before but it is worth revisiting because, like the need to recognise and overcome our behavioural biases, it is always healthy to continually question any 'expert' advice. Experts are not always wrong, however, they, like all of us, can easily lose their discipline and be swayed by behavioural biases. There have been many studies that have shown models outperform experts in diagnosing problems, interestingly when the experts are privy to the models findings their success rate improves, but it is still lower than that of the model alone. It is probable that human biases once again allowed the experts to become blinkered in some way.

Rules

There have been hundreds, probably thousands, of investment rules articulated over the years and the ironic thing is that almost all of these rules would have improved the majority of investors' performance if they had been adhered to. Even the overly simplistic, 'Buy and Hold' out performs most individual investors primarily because the majority who may start out as long term buy and hold investors lose their nerve at just the wrong time.

A set of rules cannot guarantee great success but they generally will help any individual avoid abject failure.

A famous Warren Buffett quote goes along the lines of;

'Rule 1, never lose money. Rule 2, never forget rule number 1.

This is sensible advice. Sadly it does not tell one anything about how not to lose money, however, it does highlight something that should be of paramount importance to all investors and that is the importance of capital preservation and focussing on absolute return. The investment industry throughout the almost twenty year long secular bull market of the eighties and the nineties lost sight of the importance of absolute returns, preferring instead to focus upon relative returns, but as many have pointed out in the past, 'you can't eat relative returns'.

The Warren Buffett quote above may have been slightly tongue in cheek but his observations upon the importance of keeping investment simple are not. The investment industry, possibly in its pursuit of scientific accuracy, and certainly in its pursuit of profits, has a real penchant for complication. Dennis Gartman goes further than Buffett. His investing rule 11 is;

Keep your technical systems simple. Complexity breeds confusion, simplicity breeds an ability to make decisions swiftly, and to admit an error when wrong. Simplicity breeds elegance.

More on the need for simplicity can be found in Richard Bookstaber's excellent book 'A demon of our own design'. He could have titled the book 'Complexity courts catastrophe' a phrase he utilises frequently.

One of the single most successful hedge fund managers of all time, Jim Simons, founder of hedge fund Renaissance Technologies, commented in a guest lecture at MIT;

'If you do fundamental trading, one morning you feel like a genius, the next day you feel like an idiot....by 1998 I decided we would go 100% models...we slavishly follow the model. You do whatever it (the model) says no matter how smart or dumb you think it is. And that turned out to be a wonderful business.

The Simons approach flies in the face of the pursuit of simplicity, his fund hires the smartest mathematicians, statisticians and physicists around to devise and drive their funds models, but this is not a path open to many and even with the discipline and resources that Renaissance has at its disposal it is far from a scientific guarantee they will make money. In 2012 their institutional futures fund lost 3.17% and in 2011 it lost 1.84%. However, it does highlight the value a disciplined and structured framework, within which decisions are made, can provide. But again, it must be remembered, even the best models only add discipline and believing that a scientific model exists that will assure success is a fool's errand;

On the subject of formulaic investing Phil Carret wrote in 'The Art of Speculation';

Rule 9: Ignore mechanical formulas for valuing securities.

As I have illustrated many times in the past, valuation measures, be it for an individual stock or the market as a whole, tell an investor nothing about what direction that stock or market may travel in next, EXCEPT AT HISTORICAL EXTREMES, and then only over very long time periods. The idea that such a formula may exist is indeed alluring but sadly futile.

The reason that a formulaic or scientific approach cannot exist is, as discussed at length last month, due to all of us and our perverse idiosyncrasies and biases, as it is all of us that drive the markets.

This is nothing new, it has been known for years, but repeatedly the majority lose sight of this fact. Seventy five years ago Jesse Livermore, one of the greatest traders of all time, wrote;

'There is nothing new on Wall Street or in stock speculation. What has happened in the past will happen again, and again, and again. This is because human nature does not change, and **it is human emotion, solidly built into human nature, that always gets in the way of human intelligence.**' (Emphasis added)

Merrill Lynch's legendary market timer, Bob Farrell, who I had the great good fortune to work with for a number of years in the eighties and early nineties, highlighted the same challenge in his own rules;

Rule 6: Fear and greed are stronger than long-term resolve.

What he meant by this was that emotions cloud our decisions or affect our long-term plan. Plan your trade and trade your plan would be another way of putting it.

This rule also highlights the importance of a plan if one is to have the discipline to overcome the emotional and behavioural biases.

In addition to the rules I have already mentioned, that I have sourced from others, I would add;

Investment rule 1: Avoid the comforting siren song of economic forecasters and commentators. In a bull or bear market they tell you nothing except a rough extrapolation of prevailing conditions. More importantly, at extremes they are always wrong ahead of any important turning point. (Sadly, it is probably the case that any comforting message will prove to be a siren song!)

In the pursuit of greater discipline and the avoidance of behavioural biases there are a number of other rules that an investor could usefully apply. These would include;

- Never add to a losing position (Gartman)
- Never invest on tips or inside information (Carret and Livermore)
- You do not have to be in the market all the time. There are times you should be out of the market, for emotional and economic reasons (Livermore)
- Always be aware of your emotions – don't get too confident over your wins or too despondent over your losses. You must achieve 'poise', a balance in your actions. (Livermore)
- Virtually all lists of rules and observations from experienced and successful investors includes something along the lines of; find a method or plan that works for you intellectually and emotionally and stick to it.
- Do more of that which is working and less of that which is not. (Gartman)
- Investment success can only come from being different, it is never found in the misplaced comfort of the crowd.

Applying rules

Building a portfolio from scratch requires an understanding of both long term and shorter term investment tolerances and market expectations, and also the rules that you as an investor are comfortable with. Only then can your own plan, which you are going to stick to in a highly disciplined manner, be articulated.

Phil Carret's rule number nine, regarding mechanical formulas, is important, they should be avoided, however, as I commented above, there is one metric that can almost be followed in a mechanical way, valuation. The entry point for any investment is absolutely critical as far as long term returns are concerned. Your entry price forever determines your return. This is true even though many investment commentators like to talk about the long term return of equities or the long term return of bonds. The obviousness of this observation can be seen using the example of the UK's FTSE 100 index over the last fifteen years.

An investor who bought into the buying frenzy that was seen at the end of 1999 would now have an annualised return that was slightly negative and so would still be suffering, almost fifteen years later, a small loss. Had he made his initial purchase three years later, in early 2003 he would have doubled his money having enjoyed an annualised return of about 6%. An investor in late 2007 would be in almost exactly the same position as the buyer eight years earlier with a loss after eight years; however, the brave buyer who got into the FTSE 100 in early 2009 would now have enjoyed annualised returns of about 12% and be sitting on a return of 75%. Clearly, when you buy is just as important as what you buy.

The fact that markets mean revert is an observation included in the rules and observations of many and it is certainly the case that valuations have mean reverted for more than a century. The challenge

is that the peaks and troughs of valuations have often been separated by two or more decades. This makes valuation metrics useful, but only over the very long term. Obviously the long term return of an investment that is historically cheap will be higher than the return for the same investment when it has become historically very expensive. Given this statement of the obvious we should all want to own more of what is historically cheap and less of what is historically expensive, unfortunately, almost by definition, this must be the opposite of what the majority do. What makes any asset historically expensive is that the majority are clamouring to buy at any price and the reverse is true when an asset is historically cheap.

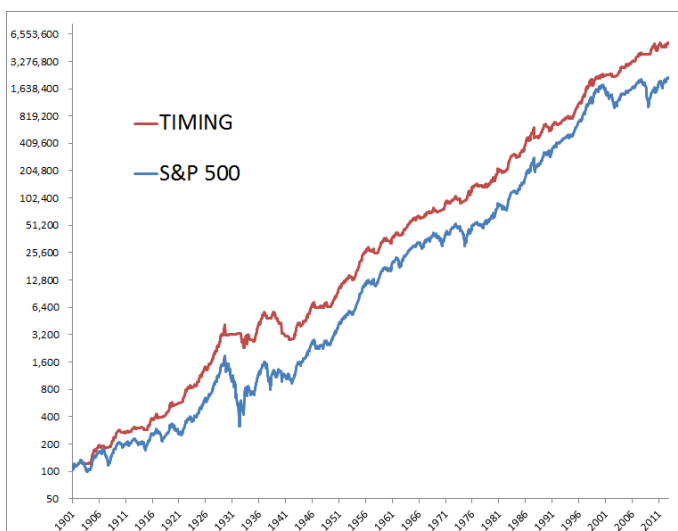
Long term strategic asset allocations (SAA), which will likely not change for many years, should be set to reflect the long term valuation of each asset included within a portfolio. This should be the starting point for any long term investment portfolio, almost irrespective of what rules or disciplines are subsequently going to be followed.

A disciplined investment plan that merely gradually adjusted long term SAA as each asset moved through its range of valuation would serve most investors well, however, it would also be very uncomfortable for long periods of time and would require great discipline to be maintained, but then discipline is the one essential shared by all great investors.

Once the SAA has been set there are a myriad of differing disciplines that can be applied to the management and maintenance of the portfolio to further improve returns. I would argue strongly that all would incorporate a disciplined set of rules and all would eschew the various siren songs so widely available, particularly those of economists.

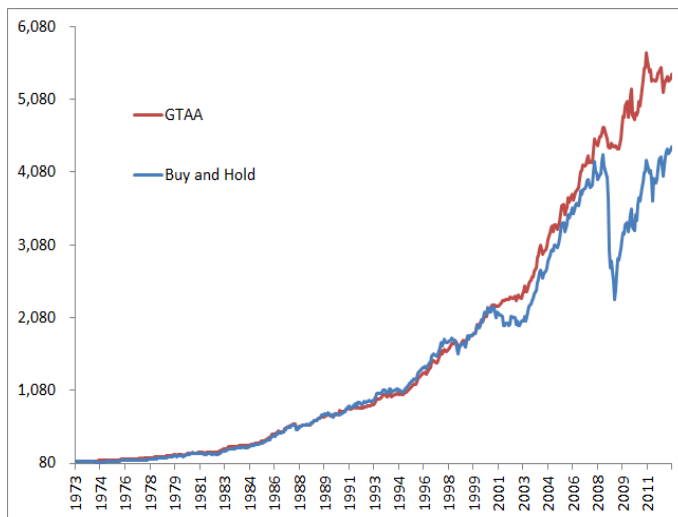
It is probably not appropriate for me to lay out the prescription of rules, parameters and indicators that I follow because, as Jesse Livermore and others have pointed out, it is essential for each investor to establish those rules and models that work for them intellectually and emotionally. What I would like to do is strongly recommend that any reader who is embarking on the process of establishing an investment portfolio read Mebane Faber's paper, 'A Quantative Approach to Tactical Asset Allocation' it can be found at; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962461

I have referred to the work of Mebane Faber several times over the years as he provides very long



term valuations on most of the major, and many of the emerging, markets of the world based upon long term cyclically adjusted price earnings ratios. In this paper, rather than dwelling on valuation measures Faber explores whether a simple rule based model could be devised that would allow an investor to avoid the most damaging periods of market volatility and capture all or even more of the upside. The simple approach was based upon the ten month moving average of the S&P500 with the rule that the market was bought when it was above the moving average and

exited when it fell below the moving average with, for simplicity, only month end measurements taken. The highly satisfactory results of this very simple approach over more than a century are shown above.



The simple rule provided a better long term return, lower volatility, lower maximum drawdowns and fewer negative months.

He then expanded the model to include five different asset classes, US stocks, foreign stocks, bonds, real estate and commodities. The same rule regarding the ten month moving average was applied to all asset classes and the results since the early seventies, compared to simply buying and holding those assets, are shown to the left.

This very simple approach was purely rule based; it avoided the risk of the investor

getting swept up in the emotional hype and euphoria of the latter stages of a bull market, or being swept down in the depressed gloom in the depths of a bear market. This simple rule meant that the very strong, and at times almost overpowering, behavioural biases that we all succumb to so easily and frequently were avoided.

Towards the end of the paper Faber outlines the possibility of utilising even more than five asset classes and also constructing more conservative and more aggressive portfolios.

Beyond stressing the absolute importance of discipline I do not want to prescribe what is right for any individual investor but I would stress that articulating a set of rules and disciplines from the outset is essential. What is right for me will quite possibly not sit comfortably either emotionally or intellectually for others, however, for my own portfolio I strongly believe that a very long term, value based, strategic asset allocation is the right approach, particularly when combined with a shorter term rule based discipline that recognises the danger of emotional and behavioural bias. Getting back to the original question of investing being an art or a science, all that I have described in no way makes investment a science, it remains very much an art, but an art that requires some structure if the lure of siren songs and behavioural bias are to be avoided.

Conclusion

As I stated in the introduction, my overall market views have not changed as a result of the action that has been seen over the last month, in fact, if anything, what has been seen has only increased my level of concern. The fact that the worst thing that majority fear is a 'healthy correction' and that so much comfort is being taken from the state of the economy continues to ring alarm bells with me. As a number of the rules I have discussed this month point out, absolute return is the only measure an individual investor should care about, preservation of capital is essential and you don't have to be in the market all the time. I continue to believe that now is one of those times.

Finally I just want to stress once again that no matter how scientific an investment approach may appear investing is not a science, in fact the more scientific and more complex an approach becomes the more circumspect an investor should become. The primary reasons it is not a science are the same reason that prevent economics being a science and revolve around the fact that it is us that drive markets (and economies) and we are all collectively far from rational as we are riddled with emotional and

behavioural biases. It is these human biases that make both economics and investment far from scientific; however investors do need RULES and DISCIPLINE to overcome and avoid biases.

Kevin Armstrong

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Prepared comments for IFA conference

Successful investment models, Art or Science?

Over the years I have learnt that when presenting on investment markets it is always best to lead off with the conclusion, just in case anyone somehow manages to drift off along the way. I have also learnt that it pays to keep the conclusion simple and short; Here goes....

“Successful investing is without question an art” And we should all be especially wary of anyone claiming to the contrary, particularly those practitioners of the pseudo-science of ECONOMICS, at least when it comes to investment markets.

I have also learnt that it pays to start off with a cartoon;

One of my all-time favourite investing cartoons was published in the New Yorker in the 80's, it shows a man watching the finance news on television. He is told;

“On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realisation that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher rates!”

We'll come back to these wonderfully circular observations in a moment, but getting back to the art....

Investing is an art that requires great DISCIPLINE, PATIENCE, and HUMILITY and to achieve success at the art practitioners MUST have a clear appreciation and understanding of just what it is that drives markets.

Sadly, what makes the endeavour of investing even more 'art like' is that the true driver of markets cannot be scientifically measured, except by the obvious effects it has on the markets themselves.

This, understandably, leads to uncertainty amongst investors.

As human beings we all hate uncertainty and amidst uncertainty we tend to look for things to hang on to, hopefully something that can be measured, to try and quell that uncertainty. These are the

‘irrational crutches’ that I used as the title for my latest Strategy Thoughts that you all should have received a copy of.

The majority of market practitioners build their views on things like those mentioned in the circular cartoon I described a few moments ago. Things that can be measured, or at least approximated..... Things like Economics, interest rates and earnings.

Economists are the most egregious purveyors of irrational crutches. What is most surprising to me is that they still get such air time..... given that the track record of economic forecasting, and then utilising that forecast to build an investment view, is so lamentable.

But they are still listened to because we want something that seems to make sense to make us feel more comfortable. If you think I am being unduly unkind Just think about what the majority of us endured prior to, through and after the GFC.

Economists were virtually to a man, upbeat ahead of the global stock market peak in late 2007. This economic optimism was then rudely embarrassed through the GFC and by early 2009 had been transformed into universal disgust about the outlook for the global economy. Then, only after markets had risen by 50% to 100% through the balance of 2009 did economists begin to concede that economic Armageddon had indeed been avoided.

On top of this there have been many studies that have shown that the correlation between the economy and the stock market is very close to zero and frequently negative, unless one has a time frame of three decades or more.

Even the Federal Reserve themselves concede that they are virtually ‘Always behind the curve’.

Still we hear analysis attempting to forecast the Fed’s actions to then tell us what markets may do. You can rest assured that the markets have already done ‘IT’. Then there is the so called Fed model, based upon the idea that interest rates and P/E ratios are closely related. Like economic views this seems intuitively sensible, sadly its track record is almost as unreliable as economic forecasts. It did work through one period from the late sixties through to the turn of the century, but prior to that period, and for much of the time since, the model has actually worked in the reverse manner to which it is ‘supposed to’. It can easily be argued that interest rates sometimes do and sometimes don’t drive markets. This isn’t a reliable model for successful investing.

One final irrational crutch is earnings. There is entire global industry focussed upon forecasting corporate earnings, and again it does seem to make sense that if earnings are rising then markets should too, and vice versa. Again history is not particularly kind to this contention.

An example of one iconic company over a very long period illustrates the value, or otherwise of forecasting earnings. Coca Cola

Late 1972 KO P/E 45x. Stock was at a long term peak, era of the ‘nifty fifty’.

Over the next nine years the stock fell by more than 70% and it’s P/E to single digits.

Sixteen years later the stock had rallied more than fifty times in value and its P/E had expanded to 57x.

For the next decade the share price fell and so did the P/E, finally getting close to single digits again.

What was most important to forecast? Earnings?

The movement in KO's earnings have accounted for only a fraction of the share price's movement over the last forty or more years. What has been far and away the primary driver of the share price has been the contraction, expansion and contraction in P/E ratios. None of these were driven by profound events or changes in the company's history. They merely reflected the huge swings in collective enthusiasm or otherwise of market participants.

This is what drives markets, the major swings in all of our collective moods over multiple time frames.

From a very long term perspective this example illustrates one measurable tool that does work, valuation, but only over very long, or secular time frames.

All asset markets have historically gone through extreme swings in valuation, from historically very very cheap, to historically very very expensive and back again. These swings tend to take decades to unfold but they should be the driver of long term strategic asset allocations. We all should want to own more of what is historically cheap and less of what is historically expensive, but in actual fact, in aggregate, we do the reverse. We must. That's why things become historically very expensive, or cheap.

Once an SAA is developed, that captures long term valuation metrics, shorter term tactical asset allocations can be utilised around that SAA to capture the shorter term mood swings that produce cyclical bull and bear markets.

Sadly, there is no 'measure' that can highlight exactly where any market is at any time, however, attempting to establish a framework of mood and expectational extremes will be far more rewarding than relying on any of the irrational crutches that deliver such misplaced comfort.

Investing is an art, and in addition to the three traits I described earlier of discipline, patience and humility, long term successful investors spend lengthy periods avoiding the sought after misplaced comfort I have described and enduring great discomfort. Comfort and success in investing rarely go hand in hand.