The Secret Sauce of Investing

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Bits & Pieces

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From time to time I present to potential clients and typically get the question: "That's all good, but why should I invest with you and not *Big Brand Investment Co*? What's your secret sauce?"

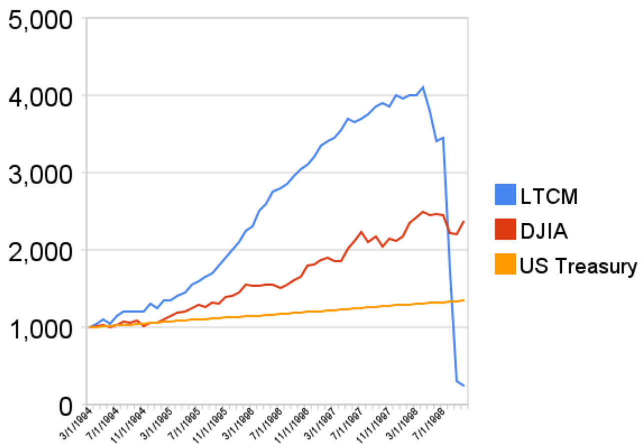
I suspect many would find this answer convincing:

> We use a firm foundation of financial principles to analyse investment opportunities and challenges…we do this by:
>
> • Uniquely integrating computer technology and mathematical models with financial theory, business experience and trading acumen, and market information flows and,
>
> • Capitalizing on financial research of the last 30 years.
>
> What distinguishes us is our remarkable talent. The quality, background and recognition of our employees is top notch. Our various strategy teams are comprised of a unique combination of specialists in trading, economics, mathematics and computer science.

What if I told you this would generate double the returns of the stock market over a three year period? Would the fund's 'edge' resonate with you?

Of course it would!

Unfortunately, I can't claim any of it. The description above comes from a now-defunct hedge fund, Long Term Capital Management (LTCM). In the mid to late nineties, LTCM boasted the smartest minds in finance, including two Nobel laureates.



Source: Wikipedia

LTCM's sophisticated models (combined with massive leverage) generated stellar return…until they didn't. LTCM blew up in 1998 after Russia defaulted on its bonds. LTCM's debt burden was thought to be a danger to the global financial system and ultimately resulted in the Fed stepping in to bail out creditors.

If Nobel Laureates can't figure out the market, who can? What's the secret sauce?

The answer: **there is no secret sauce!**

Or put more accurately: the financial alchemy that LTCM demonstrated is largely a myth. To the extent that it does appear, the overwhelming odds are that those returns are a function of **leverage, extreme risk taking, and luck**. Investors who believe they've found the Holy Grail are likely to be disappointed.

I don't believe there are any large edges. **Rather, there are only small edges which collectively compound over time.**

In my opinion, the key elements of any edge must be based on:

1. A robust strategy

An investment strategy should:

1.1 Be based on empirical evidence.

1.2 Embrace second level thinking (to paraphrase Howard Marks).

"The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function."

F. Scott Fitzgerald

First level thinking says "Buy cheap stocks", "Buy Amazon because it's taking over the world" or "Buy XYZ Co because Trump". This is where markets become complex and the logic quickly becomes circular: anything that is self-evidently true is likely to already be priced in, removing the opportunity to profit. At the same time, being a dyed in the wool contrarian is the surest way to lose your shirt.

Understanding and balancing the opposing forces of momentum (first level thinking) and mean reversion (second level thinking) is critical.

1.3 Be robust and flexible to external change.

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."

Charles Darwin

Investors frequently talk about the market as if it's a living organism. Take tens of thousands of market participants (humans and computers) responding to various stimuli and continuously trying to outcompete each other, add in a dollop of chaos, and you have a system that is quasi-biological. Unlike the Physical Sciences, where input A consistently results in output B, markets are largely unpredictable. Portfolios must be constructed with this characteristic in mind.

Natural ecosystems emphasise **robustness and survival** over **optimisation and efficiency**. A portfolio consisting 100% of Technology stocks would probably look 'optimised' today (they're leading the market — so why hold anything else?!). But it clearly fails the robustness test and could result in devastating losses.

I recently listened to an interview with Victor Haghani, a former LTCM partner. Haghani observed that LTCM's models were based on historical precedent and were ill equipped to deal with events whose severity far exceeded anything experienced until then. Put differently, their models were optimised for the neat set of scenarios of their modelled world, **but were not sufficiently robust to survive the brutality of the real world.**

"The simpler, the better. Complications lead to multiplicative chains of unanticipated effects."

Nassim Nicholas Taleb

Antifragile

As natural ecosystems evolve, so must any strategy in navigating the market. This is **not the same as flip flopping or chasing every market narrative**. It is both possible, and necessary, to stick to a core philosophy, while adapting one's tactics to the new environment. A railroad may have constituted a quality growth company in 1920; today, a company like Google is more likely to fit the description.

The best solutions for dealing with complex systems are, counterintuitively, the simplest. Humans are attracted to sophistication and cleverness, but like LTCM, too often these constructs have a fatal flaw buried deep in their core. Importantly, ***simple* is not to be confused with *simplistic***. **Superficial understanding leads to *simplistic* solutions; deep understanding leads to *simple* solutions**.

2. A willingness to accept risks that others can't or won't

It's a truism in life and on Wall Street that there are no free lunches. Unlike other fields of endeavour, being smart and working hard isn't enough to generate superior returns. Why? Because **everyone** is smart and hardworking, which nullifies the efforts of everyone else! To earn a market beating return, **investors need to accept risks, or burdens, that other investors can't or won't**.

Two important burdens are **Boredom** and **Pain**.

"If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."

George Soros

Boredom means sticking to the basic disciplines of your strategy day-in, day-out, year, after year, after year. It means being patient, saying 'No' to a lot of ideas that don't fall within the confines of one's strategy or circle of competence. Very, very few people have the self-discipline required for the grind.

I am convinced that in order to be successful, investors must also be able to endure **Pain**. I wish it were otherwise, but I suspect it's unavoidable. Pain comes in the form of losses, missing out, criticism, looking stupid, feeling stupid, loneliness and, to top it all off, client redemptions.

"The central truth of the investment business is that investment behaviour is driven by career risk...The prime directive, as Keynes knew so well, is first and last to keep your job."

Jeremy Grantham, GMO

Individuals and organisations typically avoid pain in a subtle way: through **compromise** (which sounds like a perfectly reasonable thing). It always starts with small compromises: "Can't you tweak your strategy to reduce volatility a smidgen, so your returns look a bit more like the market and your competitors?" Unfortunately, **there are no costless trade-offs**. **One merely exchanges intense, short term pain for the slower, ultimately terminal bleed of mediocrity.**

The Secret Sauce of Investing

Very few people or organisations have the capacity for pain. The major reason is career risk — who can blame fund managers for choosing to minimise pain when they have families to feed.

Of course, pain on its own is not a predictor of success: training for a marathon is painful but productive; slamming your hand in a car door is painful but idiotic! Regardless, the overriding principle stands.

Finally, there's a missing ingredient which ties these elements together: **Passion**. It's impossible to sustain the grind and stomach the pain for long periods unless you really love the investing game.

My views on the sources of investing 'edge' have evolved over time and will continue to evolve. It is an endless pursuit of 'Truth'.

"The important thing is not to stop questioning. Curiosity has its own reason for existing.

One cannot help but be in awe when he contemplates the mysteries of eternity, of life, of the marvellous structure of reality.

It is enough if one tries merely to comprehend a little of this mystery every day."

Albert Einstein.

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