WHY PHILOSOPHY MATTERS IN INVESTING

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Introduction

Why is it important to have an investment philosophy?

An investor with a well thought-out philosophy and process gives him or herself the best possible chance of outperforming the market over the long term. I put those odds at roughly 20%. This figure may seem depressingly low, but it's consistent with reality – the bulk of investors underperform their benchmarks after fees.

PERCENT OF FUNDS THAT UNDERPERFORMED THE S&P 500 AFTER FEES

Fund category	3 years	5 years	10 years
US domestic equity	87%	95%	87%
Global markets	77%	82%	81%
Emerging markets	77%	68%	82%

Source: The Concentration Manifesto, Cameron Hight, Alpha Theory.

The table above only tells half the story. Absent a robust and coherent philosophy, I believe the odds of outperforming fall to 5% or less.

The thoughts below are not intended as a prescriptive to-do list. Readers are encouraged to take the underlying principles and apply them to their own specific circumstances, beliefs, and skill-sets.

Philosophy and edge – theory and reality

We all have beliefs about how the world works. Most beliefs operate at a subconscious level – it takes work and self-awareness to recognise these underlying drivers of behaviour. Importantly, not all beliefs are consistent with reality. This creates a challenge, as humans will sooner distort reality to fit their beliefs than change their beliefs to fit reality!

If you want to be a successful investor, your beliefs must align with reality. What should work and what does work are not necessarily the same thing. The most important question when it comes to philosophy is: are there empirical and logical reasons that the market should reward you for pursuing your particular strategy? Do you have an 'edge'?

You also need to do something different from other investors. If research demonstrates that low PE stocks outperform, investors will flock to those names and destroy the strategy's future returns.

I'll provide a relevant example. 'Reversion to the mean' is taken as a universal rule in the investing world, much like gravity. While I have sympathy with this concept, I believe the really interesting outcomes are to be found when mean reversion breaks down and a new set of processes take over. In essence, I am trying to play a different game than the majority of market participants.

Within the specific context of your philosophy, you need to identify where you add value (by virtue of your specific skills) and where you don't (or worse, where you actively destroy value). I try to focus as much time as possible on the areas where I add value, and then create systems to automate (or reduce the need for decisions) in those areas where I don't add value.

Research process

Most research processes boil down to a few common steps: look for good stocks, research them, and then buy some of them. The research process only adds value to the extent that it's executed within the parameters of your investment edge. An investor cannot expect to be consistently successful in areas where they have no edge.

A major benefit of a well-defined philosophy is that it gets everyone on the same page. It helps analysts focus their research time. Counterintuitively, it's liberating to say 'No' to a lot of ideas. There's clearly a trade-off: many ideas you ignore will go on to become winners. That said, I firmly believe that the advantages of a narrow focus far outweigh the opportunity cost.

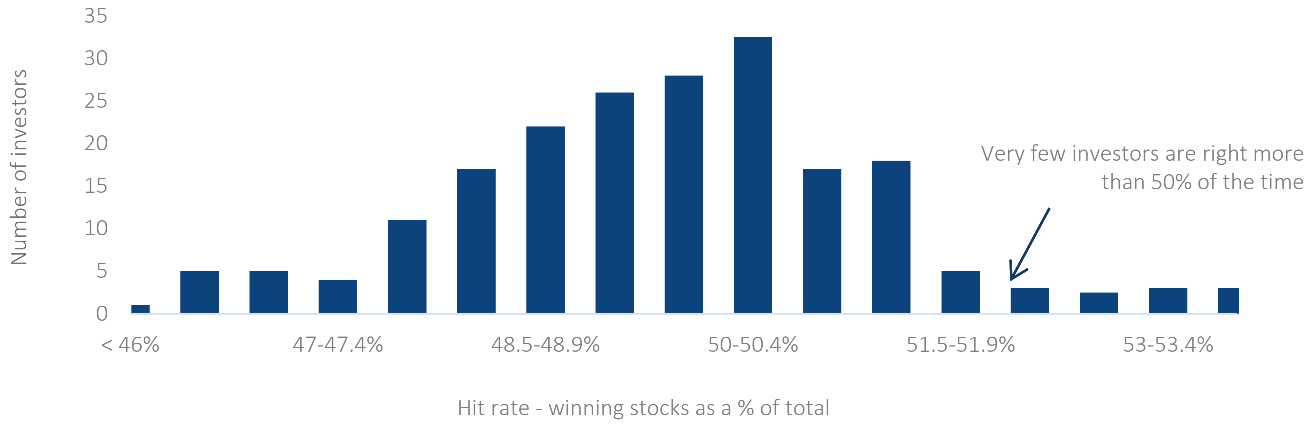
Portfolio management – three main problems

The three main problems investors need to solve with respect to their portfolios are:

1. Position sizing.
2. What to do with losing positions.
3. What to do with winning positions.

The answers to these problems are directly linked to your underlying beliefs about the market and your investing philosophy.

Figure 1: The evidence suggests most investors are right only half the time



Position sizing is arguably even more important than stock selection. The latter implies “Just pick better stocks”, but the evidence suggests this is no better than a coin toss for most investors. Even investors that are 2 standard deviations ‘good’ are only right 53% of the time.

Picking better stocks and achieving a higher hit rate is possible, but only in the context of fully embracing your philosophy (assuming it comes with an actual edge). The bulk of gains in hit rate come from moving from ‘no edge’ stocks to ‘edge’ stocks. Once you’ve done that, you tend to hit a ceiling.

Position sizing is the holy grail of investing and is arguably more important than stock selection. Getting the former right can cover a multitude of sins in the latter. What counts is how much you make when you’re right and how much you lose when you’re wrong.

Any process should explicitly articulate how you deal with both winners and losers. The approach taken should be consistent with your philosophy and beliefs. For example, a value investor will add to losing positions and reduce winning positions as the stock becomes more or less attractive relative to their estimate of intrinsic value. Conversely, a momentum investor might take the opposite approach. Regardless, knowing your strategy ahead of time adds clarity in the heat of the moment.

Characteristics of a well-functioning system

An investment process can be thought of as a system, with the different elements (e.g. philosophy, research, portfolio management etc.) interacting like cogs in a machine.

How do you know if you have a well-designed system?

The obvious answer is it generates investment performance over the long term. Shorter term, a well-designed system can and will underperform.

A well-designed system that incorporates the above elements will help the investor achieve a kind of ‘flow state’. The investor will have a deep understanding and acceptance of when the machine works and when it doesn’t. The investor will have made peace with both outcomes. The investor will have minimal internal conflicts – decisions will be clear because all aspects of belief, philosophy, skills and reality will be in sync. Once you’ve built the machine and understand its workings, it becomes easier to identify where the problems are, and which parts need fixing.

Much like a Formula One team, tweaking and improving the machine is an ongoing, iterative process. One in which each step takes you inevitably closer to defying the odds and winning the race.