

GLOBAL EQUITY INVESTING – KEEPING IT SIMPLE IN A COMPLEX WORLD

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This paper argues that there is no need to change your investment approach in a post bubble world - equally there was no need to over complicate things before the crisis. While the world is constantly changing the basics of sound long-term investing remain unchanged. Recent events create opportunity for those who remain disciplined and focused on their long term goals. The philosophies of Fisher, Graham and Buffet remain true and indeed should prosper in a post bubble environment - getting the basics (fundamentals) right will deliver long term results.

A brief perusal of the financial or business pages over the first half of 2009 would lead an investor to think that the investment world had changed dramatically. With headlines such as, 'The Toxic Trio'¹, 'Ben Bernanke discovers the limits of printing money'², 'Fed Slashes Interest Rates'³, or 'Bank of England embarks on a radical plan to print money'⁴, the world appears to presenting investors with a previously unheralded set of challenges, therefore requiring new solutions.

Certainly, the environment has been a difficult one for investors. The MSCI World Index fell around 60% from its peak in the last quarter of 2007 to its trough at the end of the first quarter of 2009. At this point, the UK's *Financial Times* was running headlines such as 'The Future of Capitalism'⁵. However, looking back in history to the late 1920s early 1930s, the Dow Jones Industrial Index fell 90% from its peak in Sept 1925 to its trough in July 1934⁶. Capitalism managed to recover from this dislocation rather effectively.

The premise of this paper is therefore that nothing has fundamentally changed. The economic backdrop or context in which companies are operating may be different, but then it is always different. In the credit-filled binge from 2002 to 2007, the pseudo scientists of Wall Street's risk and quant army dominated investors' thinking in an orgy of Greek letters and statistical models. The products offered were complex, structured solutions from an unregulated, highly leveraged, shadow banking system – but with the supposed safety of an AAA stamp.

Investors lost sight of the simple fundamentals of investing – and, if there is a need for new solutions, it is a need to return to a more traditional, transparent framework.

¹ Economist Aug 2009

² Economist Aug 2009

³ Forbes Dec 2008

⁴ Telegraph Mar 2009

⁵ Financial Times Feb 2009

⁶ Bloomberg

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How can investors avoid another (inherently unavoidable, highly unlikely, but not impossible) black swan event⁷? Part of the answer is to always be wary of the media or talking heads on television stating “this time its different”. The internet economy wasn’t a new paradigm, a ponzi scheme is still a ponzi scheme (even if it involves the whole American economy⁸), good companies and good management still display the same attributes today they did before the latest bear market.

This paper highlights some of the simple fundamentals of investing in global equities in a complex world. Some may appear old fashioned, perhaps even too simple, but have all stood the test of time in both bull and bear markets. Indeed, perhaps complex is not exactly the right descriptor for the world today - noisy is perhaps more appropriate. We live in a world where investors are bombarded with 24/7 financial news, where 0.01% prices movements in assets with complex supply and demand dynamics are confidently attributed to this or that particular factor on the day.

SIMPLE FUNDAMENTALS**Favour simplicity over complexity**

Unsurprisingly, the first key theme is to actively choose simplicity over complexity. It was Albert Einstein who once wrote, “make everything as simple as possible, but no simpler”.

The investment world has been infiltrated by maths and physics PhD’s, the ‘quants’, with their Greek letters and complex impenetrable mathematical models. They have sought to translate the certainty and immutability of Newtonian physics to financial markets, tantalised by the gigabites of data, but forgetting that human emotion, not cold rationality, is the lifeblood of financial markets.

To illustrate, financial market history is illuminating. As a result of the Asian crisis, on 17 August 1998, the Russian government and the Central Bank of Russia issued a "Joint Statement" announcing, in substance, a widening of the ruble/dollar trading band and that Russia’s ruble-denominated debt would be restructured in a manner to be announced at a later date. Russia defaulted on its sovereign debt obligations. The global ramifications were far reaching. On 4 August, the Dow fell 3.5%, three weeks later as the news from Moscow was worse, the Dow fell again – this time by 4.4%. Finally, on 31 August, the Dow fell by 6.8%.

According to standard risk models, the probability of these events was so small as to have been virtually impossible. Standard theories of risk would estimate that this final fall has a probability of 1 in 20 million. This is equivalent to saying if you traded every day for 100,000 years, you wouldn’t expect to see such a thing occur. Taken together, these three events have an even lower probability of 1 in 500 billion. Either we should all feel very lucky to have experienced such an event, or there is a problem with the model’s assumptions.

Another example is Black Wednesday, 19 Oct, 1987, one of the worst days in trading history. The Dow fell 29.2% in one day. This event has a probability of less than 1 in 10 to the power 50. Numbers

⁷ Taleb, Nassim Nicholas. The Black Swan. The Impact of the Highly Improbable, 2007

⁸ Schiff, Peter. Blog, Monday 8 June 2009

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of this magnitude are difficult to comprehend. However, to put this into perspective, these are odds so small they are completely meaningless in nature, from the scale of the smallest subatomic particle to the breadth of the entire universe, such a number would never be encountered.⁹

The best model of the real world is the real world itself. That's as simple as it can get. Simplifying it further using complex mathematical models results in flawed predictions and perhaps most importantly, a deeply flawed sense of safety. At the precise time when the protection expected from the model will materialise, it breaks down in a fat tail event. University of Chicago economist Eugene Fama, often thought of as the father of efficient market theory, famously remarked, "*Life always has a fat tail*"¹⁰.

Looking ahead, pronounced volatility appears to be a key feature of the years ahead.

Philip Fisher, considered a pioneer in the field of growth investing had a different approach. Considered by US fund research house, Morningstar, as 'one of the great investors of all time'¹¹, his approach was not complicated or revolutionary, but rather a simple focus on simple basics. Is this a quality company? Is it good at doing what it does? Is it better at doing whatever that is than its competitors and will it continue to be better? Does it relentlessly protect its core competitive advantages, whatever the outside world looks like? Does it have the resources to survive if the economic environment is not favourable? Does it have a management team with experience who knows what they are doing?

These are straightforward questions. A maths or physics PhD is not required to find the answer. What is required is some hard work with the report and accounts, some focused meetings with management and competitors or suppliers – this will reveal everything an investor needs to know about the company. This may all seem unquantifiable and difficult to measure, but so simple and effective is the outcome that Philip Fisher believed he could achieve a 90% success rate at selecting the right companies for his portfolios.¹² Warren Buffet counts Fisher as one of his key influences, describing himself once as "85% Graham and 15% Fisher".

Make independent decisions

Simply, make independent investment decisions. It sounds obvious but is surprisingly difficult to execute in practice. Following the herd is very easy. Indeed, from an investment manager's career perspective, it is very attractive, but it does a disservice to investors.

What does it require to make independent decisions? There are a few key elements that will lead in the right direction.

Independent research

⁹ All probabilities from Mandelbrot, Benoit B. *The (Mis)Behaviour of Markets*, 2005

¹⁰ Fama, Eugene H. "The Behavior of Stock Prices." *Journal of Business*, Jan 1965.

¹¹ Morningstar Stock Course 505

¹² Fisher, Philip. *Common Stocks and Uncommon Profits*

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This is the only platform for real, independent thinking. Only by doing independent research can an investment manager have the confidence and conviction to stand apart from the crowd. Without this solid foundation, decision making will be all made in the maelstrom of daily financial news and data. Better knowledge than the herd constitutes a valuable edge and informs not only an investment manager's portfolio holdings but also trading decisions, which will be demonstrated shortly. A cynic might suggest that much broker research is written with the objective of generating turnover. Also, the focus (by many, both on buy side and sell side) is on three-year forecasts, which thus tend to get priced into shares and hence be the efficient part of the stock market. What is not priced in is longer-term earnings performance, which is where an investment manager can get an edge.

When doing independent research an investment manager is not looking for insider information, although inside information would count as an edge. The risk of using it, however, is ending up in prison! The point is to see the company from the same perspective as the company – in other words, the long-term. Good companies invest for the long-term. If a company builds a factory it expects ten years of returns from it, as should an investor from its shares.

Shareholders are buying a share in a real business, not just a piece of paper. In the words of Warren Buffett, "Don't hold a stock for 10 minutes you wouldn't own for 10 years."¹³ However small, stock ownership represents ownership in the business, and a share in the profits or losses of the business after all other creditors have been satisfied.

Take a close look at management

At its simplest, every company is a pool of assets with a management team on top. Written company visit notes provide an audit trail to hold management to account from one meeting to the next.

What is good management? Energy, independent thinking and dedication, of course, but it is the less conventional that is of real interest. Warren Buffett, in his annual letter, relates the story of a meeting he held in the mid-1960s with National Fire & Marine Owner Jack Ringwalt at which he was due to close the sale of his company to Berkshire Hathaway. Ringwalt arrived late, explaining that he had been driving around looking for a parking meter with some unexpired time. That, for Mr Buffett, "was a magical moment for me. I knew then that Jack was going to be my kind of manager".

Be conservative with earnings estimates

Ignore stock market forecasts for earnings, because these provide a margin of safety. The key risk to avoid is the risk of permanent loss of capital, which can be achieved through the aforementioned independent research. If, an investor or investment manager, owns the index, they own a share of every potential crook and bankruptcy in the market. Once an investment manager is sure that a company will get from A to B, how it gets there – the path of its share price in the intervening period from A to B – is less important.

In other words, short-term volatility is irrelevant – it's what one might call temporary loss of capital – yet it's how the investment management industry defines risk. Volatility can be used to an

¹³ Buffett, Warren E

investment manager's advantage, rather than trading as a consequence of it as a result of a benchmark momentum strategy.

Stay within your circle of competence

Investment managers must recognise their limits and those of their team. At its simplest, this translates into "don't invest in what you don't understand". Doing so is actually pure uninformed gambling, akin to betting on a coin toss rather than a poker hand. Successful investing is not about not gambling, it is about controlled risk-taking only when an investment manager has a demonstrable edge.

Invest for the long term

The concept was introduced earlier. Fisher writes that timing markets is very difficult - the return is not worth the effort, or the risk of being wrong is not worth the effort¹⁴.

So why is it generally accepted that investing is about timing markets? Firstly, it is short-term share price/market moves that get all the attention. Long-term price moves, which are what really drive share price performance, don't make good television stories. Secondly, it is due to the fundamental attribution bias¹⁵, where individuals attribute success to skill and failure to bad luck. If done often enough, human nature will tend to ignore the bad calls and anchor on the good calls, giving an individual a sense that they do have the ability to time markets.

The simple solution is to identify quality companies, irrespective of the current price at which they are trading. In Buffett's words, "for some reason, people take their cues from price action rather than from values. The dumbest reason in the world to buy a stock is because it is going up."

Long-term investors can afford to be patient and wait for the price to reach an appropriate level before initiating an investment. Overpaying for anything is a recipe for destroying value.

If an investment manager has conducted independent research and makes independent decisions based upon that research, downturns can be viewed as opportunities.

Why is it difficult to time markets? The answer is illustrated by the fundamental law of active management described by Ginold and Kahn, in their seminal work, Active Portfolio Management.¹⁶

fundamental law = Active return = function of skill * Square root of breadth of opportunities

According to the above equation above, an active manager's information ratio, the quantitative measure of alpha, is a function of two factors – skill, and the breadth of investment opportunities.

¹⁴ Fisher, Philip. Common Stocks and Uncommon Profits

¹⁵ Ross, L. (1977). The intuitive psychologist and his shortcomings: Distortions in the attribution process. 'In L. Berkowitz (Ed.), *Advances in experimental social psychology* (vol. 10, pp. 173–220). New York: Academic Press.

¹⁶ Ginold, Richard C and Khan, Ronald N. *Active Portfolio Management*, Second Edition, 1999.

Herein lies the fundamental problem with market timing. It is effectively only one decision – a very narrow breadth of investment opportunity – which is adjusting the portfolio beta relative to the market. Consequently, the skill required to deliver alpha consistently is magnified many fold. Fisher concluded the effort, in terms of investment manager time, wasn't worth it.

Trading is not evidence of active management

Many in the investment management industry mistake trading – that is, portfolio turnover – as evidence of active management. But what is active management? Simply, it is deviation from the benchmark, the antithesis of passive investing (although to look at many active managers' portfolios an investor might be forgiven for thinking the opposite). Trading is totally irrelevant to the definition of active management. Or, more precisely, turnover in company names is irrelevant. Active portfolio management, in other words position size management, is essential to avoid the portfolio being unintentionally driven by market volatility.

Figure 1 below highlights the negative correlation between performance and turnover demonstrated in many studies of mutual fund performance¹⁷. It shows the results of a 2003 research report by CSFB¹⁸ of US mutual fund data which revealed that funds with lower turnover perform better over all periods of more than two years. The benefit of low turnover is demonstrated across all time periods, but taking the long term as an example, over ten years, low turnover funds beat high turnover funds by 1.6% per annum, equivalent to \$170,000 on an investment of \$1 million.

Figure 1: Turnover compared to returns

Turnover %	Annualised Return			
	1 year %	3 year %pa	5 year %pa	10 year %pa
<20	27.0	23.9	17.2	12.9
20-50	23.1	21.9	16.6	12.5
50-100	21.8	21.8	17.0	12.6
>100	17.6	19.8	15.0	11.3

Source: CFSB, Morningstar Inc, 7 Sept 1997

Very simply, practice inactivity, not hyperactivity. Having the discipline to do nothing is very valuable. Humans are programmed to want to do something, buy or sell. Done for the right reasons, doing nothing is as active a decision as a decision to buy or sell.

Despite this, the average holding period of NYSE listed stocks has fallen from between seven and eight years in the mid 1950s to 11 months.¹⁹ In 2005, John Bogle of Vanguard fame presented findings to a US Senate Committee on the average holding period of professional investors and

¹⁷ Morningstar, Inc, 7 Sept 1997

¹⁸ CSFB study in turnover 2003

¹⁹ NYSE data

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showed a similarly dramatic decline in holding period.²⁰ As Montier notes, over short periods, return from a stock is just a function of price changes, it has nothing to do with intrinsic value or discounted cash flow. It is just people punting on stocks – speculating, not investing.²¹

Concentration is the key to leveraging skill

Investment managers running global equity portfolios have the largest opportunity set of any equity manager. Investors should be on their guard to make sure their chosen investment manager is equipped to make use of it.

As an illustration of the scale of the task facing a global equity manager, there are 46 countries in the MSCI AC World Index and 35 different currencies. This equates to 1,610 decisions to predict and get right every year. At a company level, there are 1,692 individual companies in the MSCI World Index. In portfolio construction, concentration is the key to leveraging an investment manager's edge. Diversification beyond a certain point, contrary to conventional wisdom, adds risk as knowledge of companies falls. Knowing 50 companies extremely well is much better than knowing 200 vaguely.

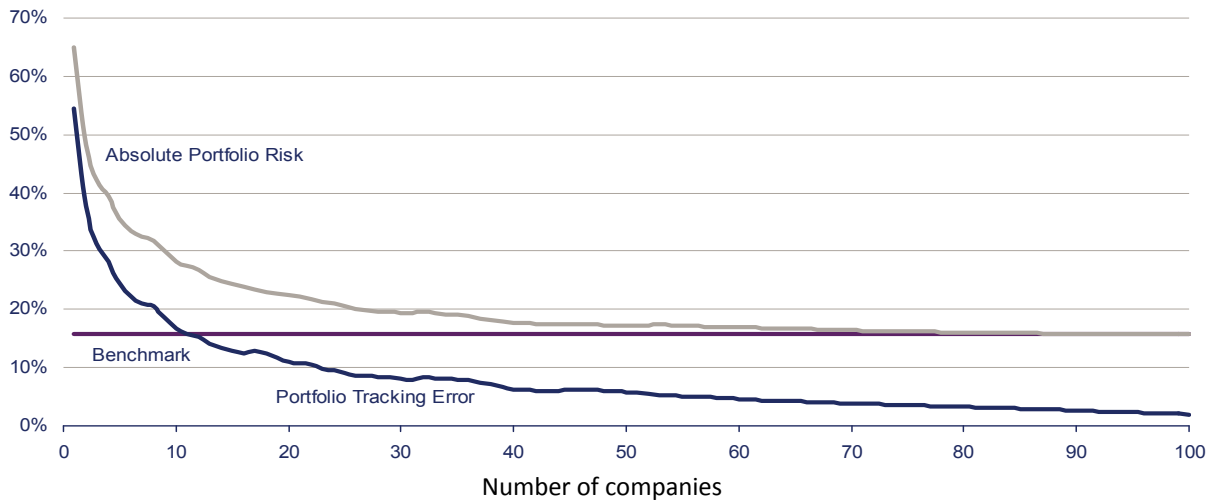
As Figure 2 below²² demonstrates, absolute portfolio risk falls dramatically in the first instance as more companies are added to a portfolio, but this diversification benefit tails off equally dramatically beyond about 50 companies. The incremental benefit of adding further companies to the portfolio is negligible, but the time required to monitor and make each of these decisions continues unreduced (in a similar way to the fixed costs of a manufacturing business).

²⁰ Bogle (2005) The Mutual Fund Industry 60 Years Later: For Better or Worse? Financial Analysts Journal, 2005

²¹ Seven Sins of Fund Management, 18 Nov 2005 James Montier Dresdner Kleinwort Wasserstein

²² Aberdeen Asset Management 2007

Figure 2: Portfolio concentration versus volatility and tracking error



Source: Aberdeen Asset Management 2007

The above phenomenon is founded on the basic observation that the chance of an investment decision contributing positively to a fund's performance is proportional to the amount of time spent on making and monitoring that decision. Since there are only so many hours in the day, a fund manager with lots of holdings is going to spend less time on each decision.

Warren Buffett describes diversification, as generally practiced by active managers, as “protection against ignorance”²³ and “a perfectly logical approach for someone who doesn’t know how to analyse businesses.”²⁴ As an investor, why pay active management fees for this?

And this idea is not new. In 1936, John Maynard Keynes wrote that “to suppose that safety-first consists in having a small gamble in a large number of different companies where I have no information to reach a good judgment, as compared with a substantial stake in a company where one’s information is adequate, strikes me as a travesty of investment policy.”²⁵

Benchmarks are not a portfolio construction tool

Driving a car while looking in the rear view mirror is very difficult. Why should investment managers build portfolios through the rear view mirror of the benchmark? Benchmark membership is no guarantee of quality, sound business or management. In owning the index, an investor is exposed to every potential crook and bankrupt out there. Benchmarks explain everything about the past, but nothing about the future prospects for a company. The benchmark weight of a stock may be the zero

²³ Buffett, Warren E. Letter to Investors, Berkshire Hathaway, 1993

²⁴ Buffett, Warren E. Letter to Investors, Berkshire Hathaway, 1993

²⁵ Keynes, John Maynard. The General Theory of Employment, Interest and Money (1936)

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risk position from the perspective of Modern Portfolio Theory (and critically from a career risk perspective for the investment manager), but whether this is a zero risk position for the investor is moot. Holding a poor quality company that loses you money is a poor decision irrespective of its weight in a benchmark.

CONCLUSION

The world is fundamentally the same, the sun still rises in the east, companies still create products and services, the good ones make profits, and invest for the future or return money to their owners, shareholders, in the form of dividends.

It is undoubtedly true that going forward, investors and investment managers will live through volatile times - in the Kondratieff Winter of the long wave Kondratieff cycle²⁶, with the Federal Reserve and the Bank of England engaging in a quantitative easing experiment, as the US Treasury and British taxpayer riding to the rescue of the wolves of Wall Street²⁷ and the Square Mile.

The answer as always – although boring in the go-go credit-fuelled binge times – is to look for transparency. Investors should seek out investment managers who have a simple, transparent process and that don't seek to hide behind false safety benchmarks or MPT risk models. Importantly, these managers must have the conviction and fortitude to stick to their process, even when the market is going against them. Only by doing independent research can an investment manager really have the anchor to make independent decisions. Outperformance is certainly not a guarantee. In fact, short-term underperformance is the only guarantee an investment manager can legitimately give. But, over the long term, good quality companies with strong management will deliver for investors.

In the words of the Oracle of Omaha, *"If a business does well, the stock eventually follows."*²⁸

²⁶ Gordon, Ian. Long Wave Group, www.longwavegroup.com/flash_pres.html

Kondratieff waves—also called Supercycles, surges, long waves or K-waves—are described as regular, sinusoidal-like cycles in the modern (capitalist) world economy. Averaging fifty and ranging from approximately forty to sixty years in length, the cycles consist of alternating periods between high sectoral growth and periods of relatively slow growth.

²⁷ Belfort, Jordan 2007. *The Wolf of Wall Street*

²⁸ Buffett, Warren. *General rules.*