Laurus
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"Chicks dig the long ball"

….Greg Maddux, 1998 Nike commercial

In a recent call with investors, Byron Wien, chief strategist of Blackstone, was asked why active managers don't outperform their index benchmarks. He provided three explanations — two well-worn, the third more novel. First, he said, a clients' tendency to dwell on short-term results penalizes any manager who underperforms in the short term. That leads managers to avoid deviating too far from the crowd. Secondly, managers have moved away from long-term investing strategies towards short-term trading.

The third, less widely-appreciated, factor Wien blamed was that the momentum created by monetary flows to ETFs and index-tracking products works against active management, and will continue to be a factor as more money chases ETFs. We all know what happens when money chases a particular stock—why should ETFs be any different?

When it comes to reviewing their investment manager, clients like to see positive performance. Remember Greg Maddux in the old Nike ad, when he looks into the camera and says "chicks dig the long ball". The fact is, investors prefer to see continuous advances in their portfolio. That leave managers stoking their portfolios with growth engines which, unfortunately, come at a price.

Yet the appropriate way to deliver strong, risk-adjusted returns to a client is to invest in companies that are unloved…assuming the client is willing to be patient. This is the main principal behind value management. Growth management – investing in companies with the potential to significantly grow their earnings over time – has been in vogue for quite some time now as evidenced by the Russell 1000 Growth index outperforming the Russell 1000 Value index over the past ten years.

Of course, it's a lonely world being a value investor given the tendency to be 'contrarian'. As Barry Ritholtz wrote in Bloomberg this month: "Remember, most of the time the contrarian investor is wrong. The vast majority of the time, the market is the crowd. Hence, making a bet against the crowd means you are fighting the market. The majority of investing dollars are the fuel that moves stocks and bonds along their long-term, multiyear trends. It is only when sentiment reaches terrific extremes that taking a position opposite the crowd can potentially produce a huge score. Even then, the timing is very, very tricky."

We live in a world that doesn't appreciate value. In the investment community, indexers are convinced that value doesn't exist or can't be reliably measured. Some investors lack a good process for analyzing the data or are too focused on trading to recognize value when they see it. While proper diversification across investments can mitigate risk and smooth returns within a portfolio, too much portfolio diversification ("protection against ignorance," in Warren Buffett's words) reduces potential for outperformance.

Similarly, behavioral finance shows how difficult it is for us to ascertain value. Our various foibles and biases make us susceptible to craving the next shiny object that comes into view and our emotions make it hard for us to trade successfully and extremely difficult to invest successfully over the longer-term. Recency bias and confirmation bias – to name just two we've written on in the past – conspire to inhibit our analysis and subdue investment performance.

Here in Canada, differentiating between value and growth is even more difficult. Apart from speculating on commodity prices, unlike the markets to our south there are very few strong investment opportunities and fewer yet that have not been well picked over. As such, most managers tend to favour growth – or, in some cases, price momentum – despite their best intentions to acquire at a discounted price.

With a lack of style determinants, perhaps we should use the George Costanza approach to make investment decisions. If every instinct you have is wrong then the opposite would have to be right. "My name is George. I'm unemployed and I live with my parents." True, I'm an admitted Seinfeld nut.

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