The Investing Edge

“We have seen much more money made and kept by ‘ordinary people’ who were temperamentally well suited for the investment process than by those who lacked this quality, even though they had extensive knowledge of finance, accounting and stock market lore.”

~ Benjamin Graham, Intelligent Investor

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In the very beginning of the book, “Intelligent investor”, the legendary investor Benjamin Graham talks about the importance of psychology in investing. He says that the chief problem of the investor is likely to be himself. He also highlights the importance of temperament over knowledge. To understand the significance of this statement one needs to understand the sources of Alpha for an investor. Here, we define Alpha as the difference between a portfolio's risk-adjusted return and the return from an appropriate benchmark.

Renowned researcher, Russell Fuller, mentions three sources of generating Alpha:

* The Information Edge
* The Analytical Edge
* The Behavioral Edge

The market price of any security reflects the consensus expectations about its future earnings and the risks associated with the outlook. The market also adjusts every day, as it prices the new information that comes in. For an investor, to predict the future change in the stock price, he/she needs to have better (more accurate) expectations about the future earnings and risks pertaining to the security than the consensus. Hence, Russell points out that the source of alpha for an investor is better expectations and one needs to have one of the three edges to attain the goal.
INFORMATION EDGE: Collecting Superior Information

Fundamental analysts and portfolio managers endeavor to collect superior information about the business and the management of the company. They try to generate superior earnings forecast about the company and the industry, thereby trying to ‘beat the market’ on information edge. However, over the years, retaining the information edge has become more difficult and expensive. With a whole lot of investors trying to collect superior information, how can an investor be sure to continuously have accurate and material information about the companies, ahead of others, all the time? Globally many funds are trying everything from drone and satellite imagery to scraping the web for real-time data to generate new and better sources of data. However, this is increasingly becoming costly.

ANALYTICAL EDGE: Processing Information better

Even if you don’t have material information earlier than the crowd, you can still generate better outcomes if you are able to process it better. Investors develop models and algorithms with enhanced predictive power to forecast the next move. Fund managers who invest based on some pure formal analytical models are quantitative managers. Here too, the problem is the somewhat similar to the information edge. One is trying to beat other investors on sophistication of one’s procedures or analytics. Ultimately, they get copied by many and stop generating superior returns. Also, what is the probability of any single investor or investment manager discovering the true factor model when so many other investors are trying to do the same thing? According to me, very low.

BEHAVIORAL EDGE: Exploiting behavioral biases

As the name suggests, this edge is achieved by superior behavior in reacting to the inputs available in order to maximize alpha. Modern finance assumes people behave with extreme rationality. However, researchers in behavioral finance have shown that this is not true. And further, these deviations away from rationality are often systematic. Behavioral managers try to exploit situations where securities are mispriced by the market because of behavioral factors.
I believe in categorizing the behavioral edge in two buckets:

a. **Taking advantage of overreaction or under reaction by the market in either direction:**

   Overreaction means investors place too much weight on recent, new information in forming their expectations regarding future events. Underreaction means investors give too little weight to recent, new information.

   The representativeness and saliency biases can cause investors to overreact to new information. These heuristic biases are probably the source of alpha for most value and contrarian strategies. Heuristics biases like anchoring and overconfidence cause underreaction. Underreaction is probably the primary source of the alpha associated with earnings surprise and short-term momentum strategies.

b. **Improving one’s own decision-making process to avoid behavioral pitfalls:**

   While forecasting and decision-making, investors are vulnerable to their own biases. Overconfidence and confirmation bias have an impact on selection of investments. Other heuristics like loss-aversion, mental accounting and regret avoidance also impact the investors’ total returns. Identifying and avoiding these mistakes can also lead to better results.

   Many investors may be using a combination of these three sources of alpha. But based on the above argument it is highly likely that strategies that incorporate behavioral edge will be able to generate better alpha for longer. Information sources may change, models can be easily copied but human behavior changes very slowly. Over the years, there has been lot of money and computing power put into generating alpha through information and analytics, but with diminishing success.

   I believe the reason is well summarized in the quote from Julius Caesar:

   “The fault, dear Brutus, is not in our stars... But in ourselves...”

   (Julius Caesar, Act I, Scene III)

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Nimesh Chandan is Head - Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called ‘Money and the Mind’.

ABOUT STOIC INVESTOR:
The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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