THE STOIC INVESTOR

REALIST | RESILIENT | RATIONAL

November 21, 2020, Issue #42

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In investing, do you think such an event, of underdogs performing better than stars is possible? Apparently, it happens a lot!

Underperformers outperform! Why and when!!

"The market is fond of making mountains out of molehills and exaggerating ordinary vicissitudes into major setbacks"

– Benjamin Graham, The Intelligent Investor

In 2001, Billy Beane, General Manager of Oakland Athletics (also known as the Oakland A's, a California based Baseball team), was stuck in a difficult position. The A's had lost the 2001 American League Divisions which he was very hopeful of winning. The contracts for all three of his star players had ended, and they were leaving to join other clubs (team owners) for 2002 matches; the Oakland team owners did not provide him with the budget to really bid for popular players. As a result of the low budget, he was outbid in every star player auction and was struggling to put together a credible team for the 2002 matches.

That's when Beane met Paul DePodesta, who gave him the idea of using analytics to choose talented players who are undervalued by other clubs. They found a flaw in the way scouts (experienced talent evaluators who recommend players for the team) and clubs used to evaluate players. The clubs used to chase glamour and pay unreasonably high amount of money for star players. Most of it was unjustified by the runs and the wins those players delivered. On the other hand, they used to reject a lot of players, who had the potential to deliver runs, for a variety of biased reasons and perceived flaws (age, appearance, personality etc.).

Beane decided to make a competitive team using analytics and recruiting players who were rejected by other teams. The scouts that worked for Oakland A's were upset with Beane on choosing such players. One of them apparently called the new selection, 'Defective players! It didn't bother Beane. He was buying players that could put runs on the board. It didn't matter what other flaws they had. This new team went on to create a record breaking 20 consecutive wins in 2002 matches! They won the 2002 American League West title and nearly won the season. Their budget was a fraction of that of the other teams they defeated.

The whole story is beautifully narrated in the book "Moneyball" (later made into a movie) by Michael Lewis. In investing, do you think such an event, of underdogs performing better than stars is possible? Apparently, it happens a lot!

BUYING 'WINS' RATHER THAN 'PLAYERS'!

"People who run baseball clubs think in terms of buying (star) players. Your goal shouldn't be to buy players. Your goal should be to buy wins. In order buy wins, you need to buy runs", says Paul. Most of the investors want to buy the stocks which are popular and glamorous. They are easy and comfortable to pick as everyone is owning them. There is a warmth being in the middle of the crowd. No one will blame you if you go wrong by buying something everyone is positive about. Unfortunately, this same comfort may be the reason for the stock to be at least fairly priced and most likely overpriced. An investor should be buying companies and businesses that are underpriced to make a good return out of them. Warren Buffett rightly said, "You can't buy what is popular and do well". Investors should be interested in buying wins (return potential of underpriced stocks) rather than players (stocks that are popular).

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The opportunities to buy underpriced companies comes when the company is undergoing some short-term trouble or is ignored for some market bias (size, name, industry etc.). These are typically underperforming stocks! In the book intelligent investor, Benjamin Graham highlights these two reasons for underperformance of stocks and hence an opportunity for investors. He says, "The market is fond of making mountains out of molehills and exaggerating ordinary vicissitudes into major setbacks". He is highlighting that overreaction on part of the investors can typically lead to sharp fall in the price of a company that is going through a cyclical downturn or a short-term issue. Also, he says, "Even a mere lack of interest or enthusiasm may impel a price decline to absurdly low levels". When a company or an industry is out of favor and the crowd is engrossed in the other parts of the market, the stock price can decline to attractive levels. Such underperformance is an attractive opportunity for smart investors. As the cycle normalizes, earnings and valuation revert towards the mean. The crowd takes notice of the same and rewards the bargain-hunting investor by raising the prices of these select underperformers.

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There are many behavioral biases that lead to such opportunities:

- Many a times, Investors and analysts suffer from **recency bias**, giving too much weight to recent events and ignore base rates
- Markets **overreact** to surprising and dramatic news flow and hence sharply overvalue or undervalue certain securities
- **Representativeness bias** makes investors think a good business is always a good investment, no matter how highly priced. They also extrapolate the high growth of the past long into the future
- Investors ignore **reversion to the mean** and reversal of the cycle

THE STOCK MARKET OVERREACTION

Unlike Billy Beane, who got results in the very first tournament after the adoption of the new system, investor in the stocks market actually need a lot of patience for their team to perform. Under pricing and over pricing of a security may persist for a long time. Also, not all underperformers become outperformers, but over time they do well as a basket. Similarly, not all winners underperform but they underperform over time as a portfolio. This brings us to the seminal work done by Richard Thaler and Werner Debondt.

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They took the monthly prices of all the stocks in the New York stock exchange from January 1926 till December 1982. They made two portfolios – A 'Winner' portfolio with 35 best performing stocks over a 3 year period and a 'Loser' portfolio with the 35 worst performing stocks over the same period. They repeated the study for a 5 year time frame as well. The time periods were chosen keeping in mind that investors would require that much amount of time to be overly optimistic or overly pessimistic about the companies. Their hypothesis was that, if the market has overreacting to the winner and losers, then in the subsequent period, the loser portfolio should outperform the winner portfolio. The test results strongly supported the hypothesis. Over the three year and five-year period, the loser portfolio handsomely outperformed the winner portfolio.

Thaler found that companies that are doing well for a long time, gather an aura of being a 'good' company and are expected to continue to grow rapidly. Expectations at some point become quite extreme and valuations quite high. These companies then become vulnerable to any negative news. The opposite is true for the underperformers. They become vulnerable to any positive news. A separate study by Chan, Jegadeesh and Lakonishok found that in the shorter duration of six to twelve months, momentum continues, and winners continue to outperform losers. The combined conclusion of these two studies suggests the need for patience for investors looking to invest in underperformers.

IS IT ALPHA OR COMPENSATION?

If the strategy of investing in underperformers (value investing or contrarian investing) pays off handsomely, is it just compensation for higher risk taking or is it really alpha? Let's answer that in two different ways:

- **Risk of loss:** When is the risk of a loss higher? When investors are too optimistic, paying high prices and valuations, expecting high growth and return in the future, having the fear of missing out, ignoring the cycle or ignoring base rates. Unfortunately, when investors don't worry about risk because it has not shown up for quite some time, the risk of loss is actually high. Underperformers as a basket represent stocks where investors probably worry too much about risk. They may have high uncertainty, but with a right investment analysis, risk can be lower.

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- **Risk of volatility:** Academicians consider volatility as the most important measure of risk. In the study by Thaler and DeBondt, the researchers show that the beta of the Loser portfolio was actually lower than the beta of the Winner portfolio. So, the winner portfolio was actually riskier.

The story of Billy Beane did have a significant impact on how the Baseball clubs selected their teams. Some were successful in combining the opinion of scouts with data analytics to improve their accuracy. Such a combination can work for investors too. Long time underperforming stocks do provide a fertile opportunity pool where investors equipped with the right investment process can score a home run.

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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).