THE STOIC INVESTOR

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The Value of Discipline

"We don't have to be smarter than the rest; we have to be more disciplined than the rest."

– Warren Buffett

James (Jim) O'Shaughnessy is a renowned investor, author and Chairman of O'Shaughnessy Asset Management. He is well known for his book 'What Works on Wall Street'. It was one of the first investment books I went through when I started my career. However, what I found most interesting about his achievements was the research he published in his first book 'Invest like the best' in 1994. In 1987, Jim worked as a consultant for various pension funds. During his tenure there, he studied the performance and portfolios of seven separate pension funds, both current and historical, in detail. He profiled the fund managers based on their strategy and the factors they used to invest on. Using this information, he prepared a set of rules that would mirror the strategy of these fund managers; in essence a clone portfolio.

In a year's time when he evaluated the performance of the clone portfolios vis a vis the fund managers (that were being cloned), he found something very interesting. All the clone portfolios were beating their fund managers in term of returns! He repeated the performance evaluation after some time intervals, yet the story was the same. What was the reason for this difference? After all, the clone portfolios were merely trying to mimic the fund managers' strategy. The difference was: Discipline. The clones followed the rules of buying and selling exactly as per the strategy, but the fund managers deviated periodically.

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There are many studies done in the past to understand the superior returns generated by certain investors over the long term. These super-investors have different strategies and investment styles. But they have one characteristic in common - Discipline. The case is the same in short term investing styles too. Jack Schwager who has written some impressive books under the 'Market Wizards' series says, "When I asked the Market Wizards what differentiated them from the majority of traders, the most common reply I got was "discipline". Success in investing is like going on a diet plan: one can learn and draw up a fantastic, high return, proven strategy on paper; but it means nothing unless followed with discipline.

YOUR KEY COMPETITOR TRIES TO BEAT YOU ON DISCIPLINE

Unless you are a passive investor in the broad-based generic benchmark of your country, your competition is mainly the broad-based generic benchmark of your country. That is the measurement of your opportunity cost and that is the competition you try to beat. How does this competitor of yours invest? Most of these indices look at market capitalization (size, based on total or free float), Liquidity (generally in trading frequency and impact cost), listing history, profitability criteria and any other country specific restriction. The companies are selected based on specified criteria that is followed by a formula-based weight allocation which is reviewed on specific periods of time. This competitor neither looks at any economic forecasts nor understands the business it is investing in.

But this competitor beats many fund managers mainly on discipline (without performance pressure!). It follows its path without worrying about what others are doing. Or if in the short term, a lot of fund managers are able to outrun it.

NEED TO BE DISCIPLINED THROUGH THE CYCLE

There are many different strategies, factors and styles that investors adopt to beat the market. Some of them don't work at all. But, of the ones that do work, none of them work all the time. Each one has a phase of underperformance. Many super-investors have undergone painful underperformance for a long period of time. None of them have 100% batting average (percentage of periods of outperformance to benchmark) and they do attract questions and criticism about their style during those periods of time. However, they have generated superior returns over a longer run because they stuck to their philosophies and did not switch their styles during downturns.

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Markets have cycles of booms and busts. Investment styles also have cycles of underperformance and outperformance. If the investors give up discipline and succumb to emotional pressures, the resultant inconsistency in decision making will more often lead to poor returns. Changes in core philosophy also impacts predictability of future performance. When an investor changes the style for example from value to momentum, the past performance becomes irrelevant in determining future expectations. The pressure to change is highest at the lowest point of underperformance. Abandoning a good investment approach during this time may lead to lack of participation in the upmove, and in a worse scenario, positions one in a downcycle of the new approach.

CLONE YOURSELF

In investing, one has to deal with complexity and uncertainty. But that doesn't mean one has to try to be extra clever and think out of the box every day. Once a good, time-tested and profitable investment approach or style is identified, one has to focus on executing it right. This approach or style can have multiple factors or combination of variables. For example, in the book, 'The Little Book that beats the Market', Joel Greenblatt speaks about the 'Magic Formula' which combines 2 factors a) business quality (Return on Capital) with b) value (Earnings yield). He shows how this simple formula delivers good index beating returns to investors over the long term. But he also highlights that the challenge is to stick with formula during the times it underperforms so that you don't miss out on the years that it delivers superior returns.

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Once you identify successful way of investing, clone yourself. Like James O'Shaughnessy did for the pension fund managers, make investment rules such that some decisions are automatic. Make an algorithm out of your secret sauce of success. This clone will keep you disciplined.

This clone should help you make the success repeatable. The algorithm should run the regular steps in the process like you would, but it should do it automatically with defined rules. For instance, steps like:

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- Screening the investment universe for the characteristics that qualify for you investment approach (Screeners)
- Ensuring the important data and analytical steps have been followed (Investment checklist)
- Undertake scenario analysis through external as well as internal estimates (Bull-Base-Bear Cases with probabilities)
- Design an ideal portfolio allocation based on probabilities and payoff with any other risk limits or criteria (Allocation formula or program)

Investors choose different styles to beat the market depending on their own skills, research, goals, time horizons etc. But irrespective of the style, a clone can act as a behavioral support system, nudging them to be disciplined and thereby helping generate superior returns from that style. In short, a clone can help an investor be stoic!

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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).