Investment Strategy: Tradition and Progress

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A long time ago (1979), I arrived in a new job: equity research analyst for a registered investment advisory firm. Armed with a science background and a modest grasp of finance, I jumped into the business of picking stocks to provide attractive performance to investors. Decades later, the time line of my career depict an interesting story of the evolution of the investment business. Progress and change is found in every industry, including the investment business. I've seen plenty of each in the past 38 years.

> "It's not the strongest that survive, not the most intelligent, but the ones most responsive to change."
>
> -Charles Darwin

Good Old Days

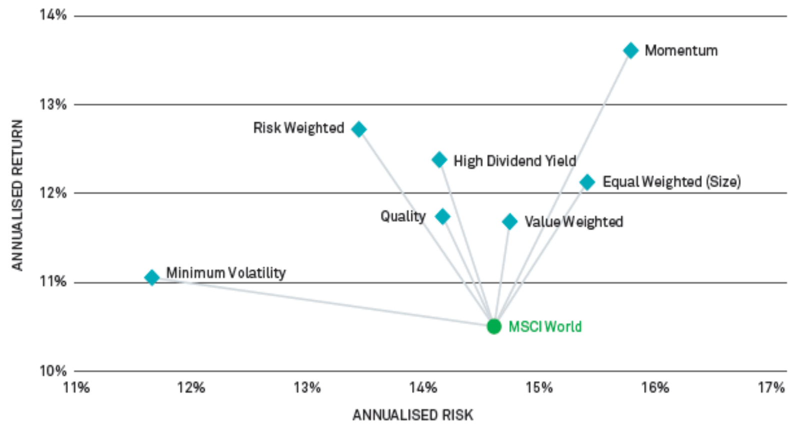
For my first decade in the job, I was a generalist. I could look at any public company, any industry based on whatever caught my attention. My fellow analysts had the same freedom. We gravitated to situations that had worked for us in the past. Computers and databases arrived on the scene gradually in the 1970s and then accelerating in the 1980s. We began screening securities databases for stocks attractively priced based on valuation statistics like price to book value and price to earnings ratios. The lists were a good place to start your search for opportunity. However, the data was expensive and often faulty. We relied on our calculators for the real analysis.

At my first employer and for many years at my own company, Clover Capital, the system worked well enough. We generally provided good returns for clients in comparison with other options. However, portfolio construction was somewhat haphazard. We were concentrated in a small number of stocks and bonds, which meant that we had little exposure to several sectors and industries. Sometimes this was intentional; many times, it was unintentional and simply a matter that none of our team had looked at the area. Thus, we differed from the market index in our portfolio composition and performance, with a portion of our difference coming from "unintended bets". Our performance, though good overall, was streaky and unpredictable from year to year. In years when our portfolios trailed the S & P 500, our clients were subject to understandable angst.

Academic Discovery and Advancement

The investment industry changed significantly through the 1990s as change was introduced on many fronts. In Academia, major advances came as studies provided deeper understanding of the factors in play with regard to stock market returns. Perhaps most important was the 1992 research paper from Eugene Fama and Kenneth French which described the structure of investment returns as being based on three factors: market risk (beta), valuation and size (capitalization).[1] The detailed and meticulous study, done by leading academic scholars, changed the dialogue on market returns and introduced a formalized approach to measuring "factor influences". While Fama & French focused on value and size as factors that are predictive of stock returns, other researchers identified stock price momentum and other factors as having predictive power as well. Factors had arrived.

Figure 1: Risk and Return of MSCI Factor Indicies



Performance of MSCI World based indices, USD, (28 November 1975 – 30 June 2015).
Source: BlackRock and MSCI as of June 2015. Past performance is not a reliable indicator of future performance.

The Efficient Market Hypothesis was first postulated by Louis Bachelier in his 1900 Ph.D. thesis. Further developed by Eugene Fama in his 1965 doctoral thesis, this Hypothesis was the bedrock of financial theory for decades. The theory holds that all information is known and reflected in the stock price. It also assumes that investors are rational and act in ways to maximize their returns. Based on this construct, there should be no systematic way to outperform the market index over time. When research in the 1980s & '90s began to identify factors such as value, size and momentum that seemed to offer systematic outperformance, we were faced with the important question of "why"? Why wouldn't supposedly rational investors flock to such factor based strategies? In the Efficient Market, they would do so until any advantage offered by these strategies wilted under the weight of the inflows. However, theses factors' advantages seemed to persist. Why these factors exist and persist even after identification came under scrutiny by economics and psychology researchers. Their efforts coalesced into a new field of study called Behavioral Finance which provided a better understanding of the human side of decision making in the world of finance and economics.

Slicing and Dicing Data

In my early days, the S & P 500 index was the primary relative measure of market opportunities. It was capitalization weighted and thus it was overwhelmingly influenced by the largest stocks. Indexes of stocks in the small cap range then emerged. In the 1990s, index providers such as Russell and Standard & Poor's created "sub-indexes" of value and growth in each size capitalization range. Also in the 90s, we saw increasing analysis of investment manager results. Morningstar and other consultants categorized managers by how their portfolios typically ranked not only by size, but now included the valuation factor. Style boxes were created. Thus, small cap value managers were compared only with other small cap value practitioners. Attribution analysis emerged and the consulting industry measured investment manager performance in increasingly sophisticated ways.

While investors now had more data and analysis of investment manager returns became more scrutinized, it is hard to say that these innovations improved investor's returns. The rise of Morningstar's service of measuring performance and assigning "stars" to mutual funds based on the ranking of their relative past results led to investors chasing past performance. The majority of investor funds flowed into the 4 and 5 star rated funds. This occurred even though Morningstar itself says that the star rankings have no predictive power for future returns. Scores of academic research proved the same. Future returns in 4 and 5 star funds were not better than 2 and 3 star returns. Still, investors had little else to use in making decisions on where to put their money, so they gravitated to the comfort of a numerical ranking system even though it didn't work.

Other odd behavior arose with the development of style box investing. Many advisors and consultants adopted a program of putting money into the "four corners"- large cap growth, large cap value, small cap growth and small cap value. Typically, equal amounts of money were put in the two large cap categories and smaller but equal amounts in the small cap categories. All the research that demonstrated the attractiveness of value over growth was ignored. In addition, the mid cap category, which offers some of the most attractive risk adjusted returns, was also ignored. As a result, the small cap growth category, which offered notoriously inferior risk and return characteristics over time, still received plenty of investor funds. Go figure! Still, style box investing arrived on the scene and continues to dominate investor perception.

Equally troubling for investor results were studies that tracked how investors in mutual funds actually fared based on their decisions to buy and sell funds over time. Starting in 1994, Dalbar, Inc (a financial services consulting firm) began tracking investor flows in and out of mutual funds. They calculate a dollar weighted return for the average fund investor based on the performance and the amount of dollars invested in the various funds over short and long term. Their analysis shows that the average investor earns a lot less than the return provided by the average fund. How? They have less money in the fund when it performs very well and more money in the fund when it performs poorly. Chasing past performance is a big part of this problem, but other investor behaviors are also at work.

> "According to the 2017 Dalbar report, for the 30 years ending 12/31/2016, the average equity mutual fund investor earned 3.98% annualized return while the S & P 500 returned 10.16%. For calendar 2016, the average equity fund investor earned 7.26% while the S & P 500 returned 11.96%"[2]

ETFs Are Born

Advancements in computing technology became firmly entrenched in the investment industry in the 1990s. Stock exchanges began to move away from the historical systems of humans trading with humans on the floor of the exchange. The new model of an exchange featured computer based exchanges where orders are placed and executed with little human interaction. This development allowed the speed of trading to increase enormously. With this speed, a new investment vehicle was born: the Exchange Traded Fund (ETF). Traditional mutual funds allow investors to buy and sell only after the markets are closed and a day's end price is established on the fund's portfolio of stocks. An ETF is essentially a mutual fund that can be traded throughout the day on an exchange. Computerization allows the ETF's underlying portfolio to be continuously repriced. Throughout the day, the price of the ETF fluctuates with investor demand. Thus, investors can buy and sell ETFs continuously and with settlement as easy as that for an individual stock. The structure utilized to create an ETF, based on a "basket of securities", offers tax benefits through tax deferment. An investor holding a mutual fund (or separately managed account) can realize capital gain every time a security within the strategy is sold, within an ETF structure capital gains can only be realized when the ETF is sold. ETFs used within a long-term investment strategy can potentially defer the payment of taxes for years. ETFs became a handy and efficient alternative for investors seeking the benefits of mutual fund diversification and investment strategies, while minimizing fees and tax consequences. Passive, index based ETFs exploded on the scene.

The New Millennium

As we entered the 2000s, the traditional fundamental approach faced several challenges. With the value factor in an extended period of underperformance during the tech craze of the late 1990s, many value investors developed a two-factor model, combining value and momentum, to screen for stock ideas. This model offered good historical performance with less deviation from the market index than simple value models. The multi factor investment model had arrived.

Developments continued in economic and behavioral research. More factors of interest emerged, including profitability measures, liquidity and low volatility. Behavioral Finance was given a rich research opportunity in the 2008 financial crisis. Many irrational behaviors were on display leading into, during and after the market panic. Post-crash, investors continued to flee from equities for many years into the sustained bull market in stocks. Many investment efforts crashed and burned in that period as losses were locked in and too much money sat on the sidelines during the market recovery. Equity exposures continued to shift, with huge flows out of actively managed funds and into passive funds and ETFs. ETF offerings expanded into a wide variety of offerings in equity, fixed income and commodity markets. By 2012, multi factor investment models reached the markets in the form of ETFs.

> "For us, one of the most exciting things about smart beta is that it is helping us build the more exact allocation we want. It means you get better risk-adjusted outcomes and have fewer surprises in terms of how your positions perform." [3]
>
> -Credit Suisse

A Blank Sheet of Paper

And that brings me to 2017. After a few years on the sidelines, the itch to go back to work in the investment field became undeniable. There are numerous ways to participate; what path should I take? Despite all the advances of the past, investors still struggle in their efforts. The Dalbar 2017 study documents that investors are still falling well short of earning the returns offered by mutual funds. Dalbar also notes that the average holding period for a mutual fund continues to decline, now at 3.8 years. Sticking with a strategy appears more difficult than ever for most investors. Anecdotal evidence suggested that many institutional portfolios were also not realizing their goals. When my old friend and colleague, Steve Carl, called to see if I had interest to start a new firm, we found we shared the allure of the opportunity to take a blank sheet of paper and fashion an investment approach that embraces the best of the developments to increase the probability of investment success. Our interests here were shared and further developed in conversations with a couple of seasoned industry professionals and High Probability Advisors was born.

We agreed on the bedrock principals of providing diversification, low costs, appropriate exposure to factors and rigorous risk management. Freed from the constraints of legacy systems, we can utilize the best technology to drive down costs and improve efficiencies, passing along these benefits to the clients. The ETF and mutual fund market offers excellent exposures to market index, factor and multi-factor exposures of all kinds at very low cost. The tax benefits inherent within ETFs increase after-tax results further optimizing net returns and the probability of exceeding our clients' goals.

"In the end, we are just human. Despite the best of our intentions, it is nearly impossible for an individual to be devoid of the emotional biases that inevitably lead to poor investment decision-making over time. This is why all great investors have strict investment disciplines that they follow to reduce the impact of human emotions."[4]

However, creating effective and efficient portfolios for our clients is not enough. We need to address the human side of the equation as well. We strive to increase the client's understanding of risk exposures and behavioral traps. In doing so, we believe we can increase the probability that the client, be it an individual or an investment committee, can find an appropriate path and stick with it through difficult times. Achieving this understanding requires a robust risk management process. We will provide ongoing analysis of risk exposures with each client report. The knowledge of how your portfolio is likely to react to rising interest rates, changes in commodity prices or a stock market correction will help the client put actual challenging events in perspective. Continuous review of behavioral biases will also help avoid the negative consequences of these traps.

In our view, combining these various disciplines and products will allow us to guide our clients to a high probability of reaching their investment goals. We also know that progress will continue; we are committed to embracing change whenever we see the opportunity to improve our client's outcomes. From a blank sheet, we created the best systematic approach to investment success that we could envision. Our focus is on client success. Obviously, it is easy to be committed and enthusiastic with such an effort. I am energized by the opportunity to continue my career path, working with a creative team in pursuit of investment excellence for our clients.

1 Fama and French "The Cross Section of Expected Stock Returns" (June 1992), Journal of Finance, 47 (2), 427-465.
2 Lance Roberts, Seeking Alpha (September 26,2017), 1
3 BlackRock, Smart Beta Guide (2015), 36
4 Lance Roberts, Seeking Alpha (September 26,2017), 3