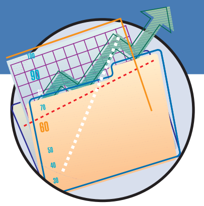

Guts, Courage, and Strategy

"What do we do when historically powerful variables stop working?" Five experts discuss the challenges of investing in a radically altered market environment

BY CHRISTOPHER WRIGHT

KEY POINTS

- Stock price may reflect hundreds of variables; the key for a good strategist is identifying the critical few factors that can make a critical difference in a particular period.
- During major market shifts, a manager's experience, temperament, and adaptability may become more important than a rigorous methodology.
- Given the tension between top-down and bottom-up approaches in the investment decision-making process, properly defining the role of industry-level analysts is important because analyst insights can exert a significant influence on portfolio performance.
- For some managers, price trumps "outlook" because they believe price paid is likely to be more important than accurately gauging macro trends.

PROFESSIONAL PRACTICE

It's an old story—managers have a hot hand for a while, but then something in the environment changes and they lose their touch. Strategies that worked stop working as a result of changes in big money flows, risk appetite, geopolitics, demographics, important macro relationships, or other factors that managers aren't able to identify right away. As famed strategist Byron Wien, producer of a much-anticipated annual predictions list, once said, "There are hundreds of variables that reflect on the stock market and some of them are very important at certain times and unimportant at other times. The skill of a strategist is to know what counts when."[1]


Byron Wien

As part of an exclusive *CFA Magazine* roundtable discussion, Wien, now vice chairman of Blackstone Advisory Services in New York, kindly elaborated on his remarks for *CFA Magazine*, and four industry professionals with distinctly different views shared their reactions:

Debra Fiakas, CFA (founder and managing director of Crystal Equity Research in New York), Lloyd Kurtz, CFA (chief investment officer at Nelson Capital Management [a Wells Fargo subsidiary] in Palo Alto, California), James Roumell (portfolio manager of Roumell Opportunistic Value Fund for Roumell Asset Management in Washington, DC), and James Valentine, CFA (author of *Best Practices for Equity Research Analysts*—he's based in Greenwich, Connecticut).

Byron, can you give us some examples of what you meant?

Wien: Sure. First, sentiment works at extremes. In March 2009, sentiment was very negative. When sentiment is profoundly negative, that's usually a good buying opportunity. I was bullish at that point, and focusing on negative sentiment served me very well. At the end of 2010, a lot of people, particularly hedge funds, were out of the market because sentiment was so positive. But I still felt the market was going higher—because the fundamentals were powerful enough—and the hedge funds would be trapped and forced to go in. So, there's a case where you had to look behind the indicator and second-guess it.

Second, superior economic growth usually leads to investment performance, as in the developing world where economies are growing much faster than the mature economies of Europe, the United States, and Japan. But you have to look at a new factor now—inflation. All the developing countries have serious inflation and have engaged in restrictive monetary policy to fight it. This could abort their growth or at least slow it down. You can't just look at growth alone; you have to look at what monetary policy in the country is doing at the same time.

Finally, there used to be a pretty tight relationship between the 10-year U.S. Treasury yield and the S&P 500. As the yield went down, the multiple went up and the S&P 500 rose. But interest rates are aberrationally low right now, and the market is nowhere near where it would be under the old "Fed model." That tool worked very well in the 1982–1999 period but hasn't worked since. The relationship is no longer anywhere near as tight as it was. I can imagine a world where it will work again, but that's a world without the kind of fear that's driving people into Treasuries.

Debra, how do you navigate the shifting sands?

Fiakas: Byron elegantly sums up how many of us have remained in business as research analysts and portfolio managers despite the vicissitudes of a cold and heartless market. Even those who have tried using quantitative approaches to investment decisions eventually reach the point at which their algorithms, formulas, and computer-driven execution strategies are just too static and thus are rendered invalid by rapidly changing and unanticipated circumstances. As the U.S. mortgage crisis began unfolding in 2007, the returns on hedge funds using quantitative strategies began heading south as well. So, if it is not some sort of quantitative formula, what is the secret of Wien's skilled strategist?


Debra Fiakas, CFA

1 "Capital Markets Q&A with Byron Wien," *NAREIT Portfolio Magazine* (2005).

I posit that it is simply the application of experience, perhaps even gut instinct, mixed with a bit of courage to make a choice even as the tectonic plates are shifting under your feet.

Kurtz: One sign that things are getting too warm is when we start to compromise on earnings quality. Late in every bull market, someone big and important is lying about their earnings. Sometimes, if you look carefully, you can tell. Enron's financial statements bulged with suspicious disclosures. The following e-mail exchange between Lehman executives regarding the now infamous "Repo 105" should be a reminder of how corporate managers think under the performance pressure of a bull market:

- "It's basically window-dressing."
- "I see… so it's legally do-able but doesn't look good when we actually do it? Does the rest of the street do it? Also is that why we have so much BS [balance sheet] to Rates Europe?"
- "Yes, No and yes. :)"


Lloyd Kurtz, CFA

The better things are going, the richer you feel, the happier your colleagues are, the greater the likelihood that there is a big lie in your portfolio. Look for it.

Roumell: Our purchases of corporate debt in 2009 at deep discounts to par value well illustrate how, in our view, price trumps outlook. The "hundreds of variables" that Byron alludes to are mostly irrelevant to a business-oriented investor focused on deeply understanding individual securities. Macro strategists offer little insight when evaluating individual companies' actual economic attributes: assets, earnings power, secular trends, competitive landscape, and management strength. It is true that individual companies trade in a market that waxes and wanes with various inputs, but the question the investor must ask is: To what extent can studying widely followed inputs (expected GDP growth rates, interest rates, and the like) provide value to individual security selection? We firmly believe that obsessing about "price paid" is far more impactful to securing respectable returns than gauging what John Maynard Keynes referred to as the average opinion of the average opinion.

Valentine: Even though strategists such as Byron look at the market from a top-down perspective while analysts typically look from bottom up, both are seeking the few, elusive, ever-changing factors that help identify where consensus is wrong. There still remains the age-old question as to the level of input an industry-level analyst should have in forecasting sector timing, because it's so influential on a portfolio's performance. Some would say sector timing is the responsibility of portfolio managers and strategists because they have such broad perspectives, but analysts often are evaluated for their performance relative to a broader index, such as the S&P 500. Conversely, asking analysts to have an out-of-consensus view on macro factors, such as economic growth, inflation, or the overall market valuation levels, can diminish the value of their bottom-up call. If a tech analyst has a great stock call based on proprietary research around a new product, should it take a back seat to his out-of-consensus view that the economy is going to slow? One way to de-stress this tension is for the analyst to provide a range of price targets rather than a single-point estimate, including one that uses a consensus macro view so the industry-level work can be reviewed in isolation.


James Valentine, CFA

Kurtz: So, what do we do when historically powerful variables stop working? Such factors often regain efficacy as the market backdrop changes. But in some cases—earnings surprise, for example—we'll probably never see a return to the old dynamics. It's not enough to know something has worked in the past, even in a particular market setting. We have to understand it well enough to believe it can work again.

Roumell: Debra makes a good point when she discusses the limitations of formulas, algorithms, and other quant-like strategies. Though difficult to describe and certainly impossible to bottle, instincts and temperament are a good part of any successful manager's track record. Jim Valentine's comment about the interplay between bottom-up convictions, however derived, and top-down considerations is particularly relevant for us now, given our belief that serious macro problems exist. However, in the end, we believe great investing is about arbitraging price versus value—period.


James Roumell

Fiakas: I appreciate James Roumell's perspective on obsessing about price. This is another way of expressing the "buy low, sell high" principle of investing. In asking the question of whether there is value at the current price, the analyst is in a position to select among all factors to determine which are relevant for the present situation and then apply them evenly without consideration of what the rest of the "herd" is doing. This is the quintessential "non-consensus" viewpoint that Jim Valentine seeks that can deliver higher returns than the market averages.

Christopher Wright of Arlington, Virginia, continuously updates the "Great Thoughts from Great Investors" page on his website www.sinewaveinvestor.com.

RECOMMENDED RESOURCES

"Asset and Risk Management in a Post-Crisis Market" *CFA Institute Conference Proceedings Quarterly* (March 2011) (www.cfapubs.org)

"The Possible Misdiagnosis of a Crisis" *Financial Analysts Journal* (March/April 2011) (www.cfapubs.org)

"Investment Management after the Global Financial Crisis" *Research Foundation Monograph* (October 2010) (www.cfapubs.org)