ALLAN GRAY
CONTRARIAN INVESTING

FOUR KEY PRINCIPLES FOR MANAGER SELECTION

CONTENTS

ABOUT THE CONTRIBUTORS

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Julian joined Allan Gray Australia in 2010 as a Relationship Manager and was later appointed National Key Account Manager. His role was later extended to manage research relationships and keep the market abreast of our portfolios, ensuring a deep understanding of our contrarian investment philosophy. Previously he held roles with Morgan Stanley Investment Management in both London and Sydney. Julian is a member of the Allan Gray Australia Executive Team and holds a Bachelor of Arts (Honours – University of Sheffield); and the Chartered Financial Analyst designation. He also has a keen interest in the field of behavioural finance, pursued through both academic study and practical experience over the last 20 years.

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Allan Gray Australia and Orbis Investments are privately-owned sister companies. Both were founded by Dr Allan Gray and share the same long-term, contrarian investment philosophy. Graeme joined Orbis Investments in 1997 and has worked as an analyst, in risk management, quantitative analysis and equities. Previously, he was a junior research fellow at Oxford University. He holds a Doctor of Philosophy (Cambridge) and holds the Chartered Financial Analyst designation.

OVERVIEW

EVERY INVESTMENT MANAGEMENT FIRM CLAIMS IT IS DIFFERENT FROM ITS COMPETITORS – A SUPERIOR INVESTMENT TEAM, AN INNOVATIVE INVESTMENT STRATEGY, AND GENERALLY FOCUSING ON THINGS OTHERS MISS.

Yet many firms produce results that are anything but different. This paper argues that to enjoy a sustainable advantage, an investment manager must be comfortable being very different from the crowd – behaviour that is guided by four key principles:

1. Make alignment of interest a key principle
2. Think like a long-term business owner
3. Avoid overconfidence and accept uncertainty
4. Oppose consensus

This paper was first published in 2012 in connection with a Portfolio Construction Forum conference, with certain updates made since. This version was released in June 2020, and updated in March 2021.

INTRODUCTION

EVERY YEAR, PERFORMANCE SCORECARDS HIGHLIGHT THAT THE MAJORITY OF ACTIVE FUND MANAGERS UNDERPERFORM THEIR BROAD MARKET BENCHMARKS OVER MOST TIME PERIODS.

Over the past 15 years, 84% of large cap Australian equity active managers underperformed the ASX 200 benchmark. Rather than being a revelation, this is an obvious outcome of herd behaviour. If fund managers hold similar positions to the benchmark, and charge an active fee, they should be expected to underperform after fees.

In a market with no shortage of active managers to choose from, investors may have come to realise that there is little difference between most of them. In some cases there may be little difference between the active manager and a passive approach. Investors therefore determine that the service they are receiving is not worth the fee they are paying.

An active manager's proposition at its heart should be simple – that they can provide a service that is **distinct, transparent** and has a **sustainable advantage** over a passive approach. If these criteria are not met, they do not deserve their management fee.

Whilst apparently simple, these criteria present a deceptively high hurdle but if executed can provide the manager and their clients with a competitive advantage.

If an investment approach is not **distinct** from others, then the proposition can only be based on cost and should be available cheaply. If it is not **transparent**, it means the investor does not understand what the manager is doing, and the level of trust may always be limited (not a good foundation for a long-term investment).

Lastly, if an investment approach offers transparency, how can it offer a **sustainable advantage**? Surely any distinct features will be competed away?

Therefore, for a manager's service to add value sustainably, **it must be difficult to replicate**.

Investors who wish to 'think outside the box' may then ask:

"How do I identify an approach which offers a sustainable advantage and is transparent, yet is difficult to replicate?"

And that is the purpose of this paper - to identify key principles that most investors find difficult to implement due to poorly aligned incentives and investment psychology. This paper argues that these principles form natural barriers to 'outside the box investing', and most investors will be unwilling or unable to apply them diligently. Investors who can apply these principles can enjoy a competitive advantage, and a rewarding and sustainable strategy.

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[1] S&P Dow Jones Indices, SPIVA Australia Scorecard, (Mid Year 2019)

THE FOUR KEY PRINCIPLES FOR MANAGER SELECTION

THE BARRIERS TO THINKING OUTSIDE THE BOX ARE ADDRESSED UNDER FOUR KEY PRINCIPLES, EACH OF WHICH TEND TO PROVE DIFFICULT FOR INVESTORS TO IMPLEMENT CONSISTENTLY.

1. MAKE ALIGNMENT OF INTEREST A KEY PRINCIPLE

For investors that engage fund managers or advisers in their investment activities, and for the intermediaries themselves, alignment of interest is of critical importance.

Fund managers' 'career risk' is perhaps the most widespread threat to alignment of interest in the investment industry.

In the parlance of investment management, 'career risk' refers to the risk of being fired by a client or employer for relative underperformance versus peers. Fear of being fired can directly influence investment behaviour amongst managers. The risk is that the manager places their own best interests (keeping their job), ahead of their clients' best interests (long-term investment outcomes).

The reason career risk is such a widespread problem is that self-interest is a natural part of human behaviour, and not reserved solely for evil, money-grabbing personalities. Demonstrating this, a 1973 study[2] recruited seminary students for an experiment. After completing a questionnaire on their religion, each was instructed to go to another building where they were to prepare and deliver a presentation (the topic being either seminary jobs or the story of the Good Samaritan). The subjects were given varied time pressures for their task.

On the way to complete their task, they encountered a man slumped in a doorway (an actor), who moaned as they walked by. The experiment was to find out whether the students would stop to help, and whether willingness to help would be affected by time pressure to do well in a task (self-interest). The results were telling, and the level of time pressure had a major effect. In 'low-hurry' situations, 63% of students helped the man. In 'high-hurry' situations, only 10% helped – some stepping right over him.

Even for religious students, self-interest can overpower the will to act in the best interest of others. As a feature of human behaviour, it is a problem that must be taken seriously.

Back in the world of investments, this corresponds to the fund manager who fails to proceed with an unpopular but outstanding investment opportunity (best interest of client) because it carries too great a risk of looking wrong alone and loss of job (self-interest).

The same risk applies in not holding a company that everyone else does hold. In this instance, the manager may conclude *'This company is 10% of the index, and everyone else holds it – having zero exposure is too risky'*. Career risk may thus lead fundamental investors to make non-fundamental decisions.

Well defined limits on active decision-making may look appealing for the fund manager when viewed through the career risk prism. Importantly, it can lead managers to make a career-safe decision ahead of their best investment decision. The following trade off simplifies the thought process:

As a fund manager, would you prefer?

A: 60% chance of double bonus and 40% chance of zero bonus

B: Guaranteed average bonus

The suggestion here, based on behavioural experiments[3], is that managers will prefer the certainty of option B.

There is no single definition of career risk, but Jeremy Grantham articulated the concept succinctly in a newsletter:

"The central truth of the investment business is that investment behaviour is driven by career risk. In the professional investment business we are all agents, managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority 'go with the flow', either completely or partially. This creates herding, or momentum, which drives prices far above or far below fair price. There are many other inefficiencies in market pricing, but this is by far the largest."4 This poses a serious problem for the professional investor. They can pursue with conviction active investment choices they believe will lead to the best long-term outcomes for clients, whilst accepting the risk of being fired. Or they can accept limits on their active decision making and performance expectations, in return for a reduced risk of getting fired.

This is not a new problem. The following excerpt is from an article written in 1974. It does not use the term 'career risk', but it is clearly discussing the same behaviour.

"Job security is most important in considering the manager's assumptions. Through economy drives and reorganizations, skilled investment people have been thrust out into an unreceptive job market.

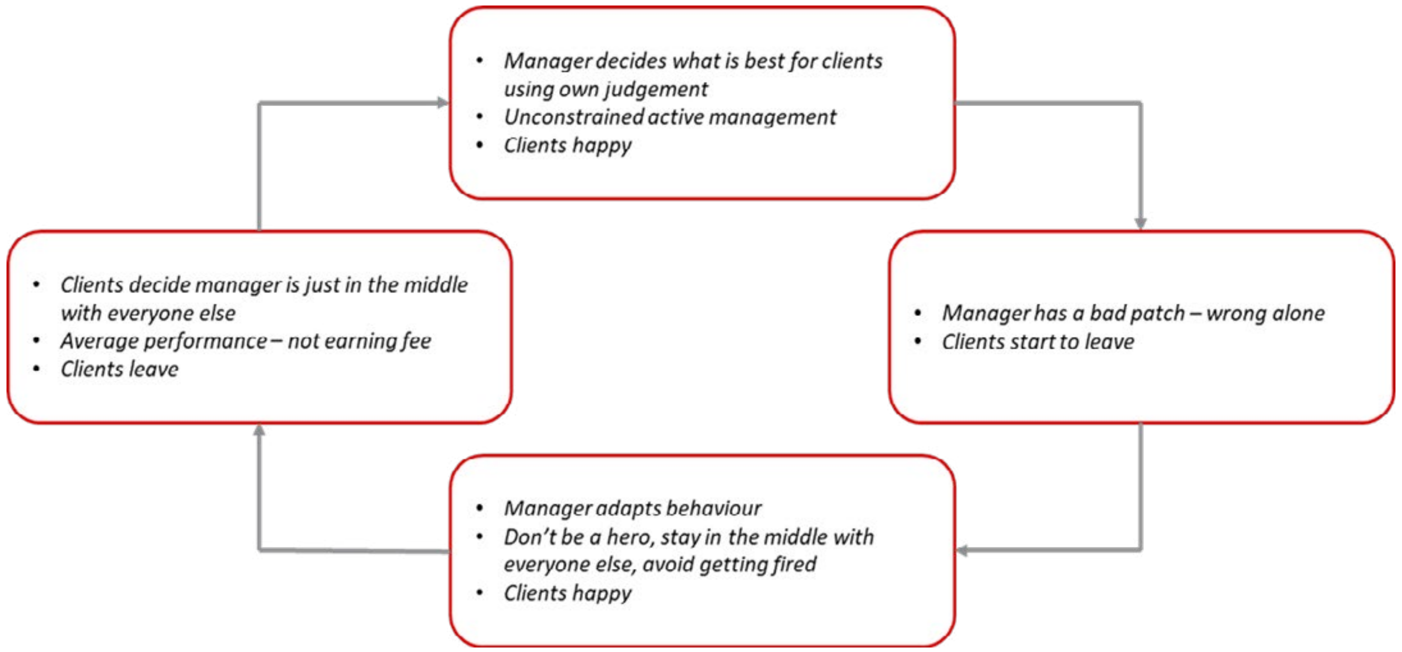
Those who remain have a message: you do not win by trying to be a hero; stay in the middle as an unnoticed team-player, and feed your family. It has long been recognized that short-term job considerations penalize creative work; hence the tenure system in academia. The investment manager had been threatened at his most critical level, his own survival, and he may have put his own immediate interests ahead of those of his clients. If so, he has lost the principal mark of a professional, his independence and his ability to completely represent interests other than his own even if they are in conflict with his own."[5]

The above excerpt finishes with a profound statement that underscores the importance of alignment of interest. If career risk (self-interest) exerts a meaningful influence on a manager's investment decision, can they really be considered an investment professional?

[2] Darley, J. M., and Batson, C.D., From Jerusalem to Jericho: A study of Situational and Dispositional Variables in Helping Behavior, Journal of Personality and Social Psychology, Vol 27. No. 1 (1973)

3 Kahneman, D., and Tversky, A., Prospect Theory: An Analysis of Decision under Risk, Econometrica, Vol. 47, No. 2 (March, 1979)
4 Grantham, J., My Sister's Pension Assets and Agency Problems, GMO Quarterly Letter (April 2012)
5 LeBaron, D., A Psychological Profile of the Portfolio Manager, Journal of Portfolio Management, vol 1, no. 1 (Fall) (1973)

Today we may be observing the irony of this behaviour running full circle. In adapting behaviour to appease clients and reduce the risk of getting fired, managers may have destroyed their value proposition which, in turn, may get them fired.



If an active manager truly believes in their ability to add value, they should stick to their investment convictions. They should be prepared to have clients leave them for short-term underperformance if that is the result of their investment beliefs. They should not rotate their behaviour in reaction to client demands, or launch products to capture short-term trends. They should focus on their own behaviour and not that of others.

What features can inform an investor that a manager's self-interest and that of their clients is better aligned to mitigate the effect of career risk?

(a) Better alignment through ownership structure, co-investment and performance fees

Consistent implementation of investment philosophy depends on the investment team being willing and able to fulfil this. Given the problem of career risk, it is preferable if they are incentivised to pursue their investment convictions, regardless of whether their approach is in favour with the investment community.

The following factors can all play powerful roles in aligning the interests of the fund manager with the interests of fund investors.

Employee ownership (by portfolio managers)
Should be specific to the strategy they are responsible for.

Alignment of interest is diluted if:

i) Equity ownership is for a broader asset management firm with other strategies that the individual is not responsible for

ii) Equity ownership is for a broader financial services firm, where the asset management operation is only one of several divisions.

Co-investment

The importance of co-investment in aligning interests is well explained in a 2019 Alternative Investment Management Association (AIMA) research paper. While written in relation to hedge funds, their findings and guidance are just as relevant to the broader managed fund industry.

They explain, "The notion of having 'skin in the game' is centuries old… Equity investors like to see that senior executives (including the CEO) of the companies in which they invest hold a significant shareholding, and that any remuneration packages include incentives comprised of stockholdings of the company. For hedge funds, this will take the form of the fund's investment principals deploying a meaningful portion of their own personal capital in the funds which they manage. This will ensure that in the event their fund underperforms and loses money for their investors, they would also lose out."[6]

Performance fees
The same AIMA research paper referenced above goes on to explain, "Performance fees are a simple but effective method of creating hedge fund 'skin in the game'. A performance fee creates an alignment of interest between the investor and the hedge-fund manager in that both profit when the fund performs strongly."

Care must be taken of course to ensure that the structure is fair and reasonable. This would include matters such as ensuring a fair balance between base fee and performance fee, a fair outperformance benchmark for performance fees, and high water marks that demand all prior underperformance must be made up before performance fees can be charged.

[6] Alternative Investment Management Association, In Harmony – How hedge funds and investors continue to strike the right note in aligning interests (July 2019)

Alignment of interest has also been considered in detail by John Kay in a review commissioned by the UK government on equity markets and long-term decision making.[7]

The Kay Review identified the issue of career risk following interviews with fund managers:

"Another large fund manager put it particularly clearly "For the investment manager, the risk is underperformance against the selected benchmark". We were told that the result of all these pressures was frequent resort to 'closet indexation'. Although those who appointed asset managers were seeking – and paying for – active management, the portfolios that were constructed for them tended closely to follow the index."

The consequences of such behaviour is dire, and closet indexing is prevalent in the Australian managed fund scene. Analysing Morningstar data as at the end of November 2019, we find that the average active share of the five largest active Australian equity managers is 46.4%. Martin Cremers and Antti Petajisto of the Yale School of Management, in their 2009 paper 'How Active is Your Fund Manager? A New Measure that Predicts Performance'[8], argue that funds with an active share below 60% should be avoided because they are likely charging high fees for providing index-like returns. This seems to be supported by the same SPIVA scorecard referenced earlier where 84% of Australian large cap active managers underperformed over 15 years.[9]

Employee ownership, co-investment and performance fees help to safeguard against a drift toward closet indexation as a managed fund gathers more assets under management, by directly aligning the interests of the manager with the interests of the investors in achieving returns exceeding those of the relevant benchmark.

(b) Better alignment through active protection of shareholder interests

The willingness and capability of an investment manager to protect the interests of their investors through shareholder activism can meaningfully impact investment performance and the protection of shareholder capital.

Where managers represent a significant holding in a company they have greater ability to influence decisions on governance issues. If they can demonstrate that they will use their influence to actively pursue shareholders' best interest, this can add to their value proposition.

The potential for positive impact is significant, according to a 2018 report on Shareholder Activism prepared by the Australian law firm Gilbert & Tobin.

"Having watched the damage of long, drawn-out activist defences, directors and management are increasingly willing to listen to the strategies offered by activists and arriving at a compromise is more common. This is well demonstrated by an increasing proportion of public activist demands that are at least partially satisfied.

With just 5% of a company's shares, a shareholder can requisition a general meeting to put a resolution to shareholders… Access to these legal tools often means that management has little alternative but to meet with and listen to activists. Often the mere threat of shareholder resolution is enough to force change."[10]

Despite the potential for positive influence, the record of Australian shareholders on matters of corporate governance cannot be described as active.

The reason for the more passive stance we have historically seen may be the self-perception of portfolio managers and investors as 'money managers' or 'share investors' as opposed to a business owner.

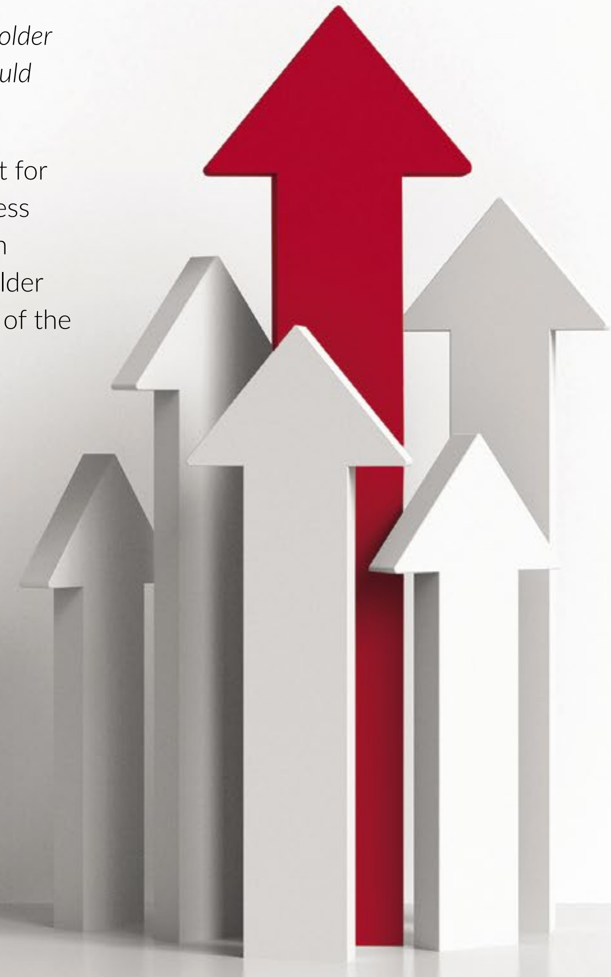
For an investor that truly believes in the business, however, one might expect a more active approach.

Some simple, common sense suggestions on this front come from then Australian Shareholders Association director, Stephen Mayne in 2008:

"Could I urge you all to become shareholder activists? Read your annual reports and Notices of Meetings. Attend AGMs and ask questions. Keep the directors on their toes by asking questions and making comments.

Don't ever forget that as a shareholder you are a business owner and should think like a business owner."[11]

The importance of this last point for investors – thinking like a business owner – goes much further than solely the protection of shareholder interests. As such it is the focus of the next section.



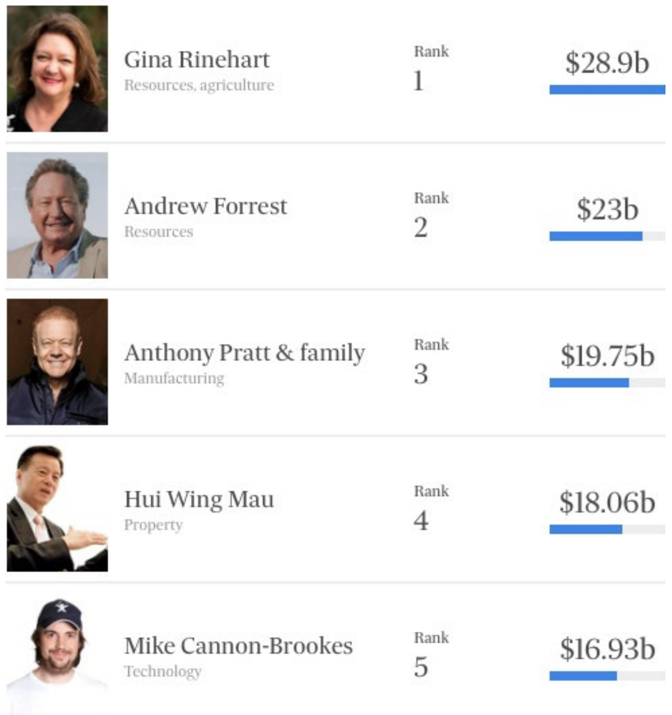
[7] Kay, J., The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report (July 2012)
[8] Cremers, K., and Petajisto, A., How Active is Your Fund Manager? A New Measure That Predicts Performance (March 2009)
[9] S&P Dow Jones Indices, SPIVA Australia Scorecard (Mid Year 2019)

[10] Gilbert & Tobin, Shareholder Activism Report, https://www.gtlaw.com.au/insights/australian-shareholder-activism-report-2018 (September 2018)
[11] Mayne, S., Presentation to Australian Shareholders Association (July 2008)

2. THINK LIKE A LONG-TERM BUSINESS OWNER

When thinking about how to approach building long-term wealth, there are lessons to be learned from looking at the well-known rich lists.

Australian Financial Review Rich List[12]



The order of these lists may vary according to the relative fortunes of different industries. What doesn't change is that they are repeatedly dominated by those who have founded, built and owned a successful company over time.

Of the top 50 members of last year's AFR Rich 200, 70 percent hold more than half of their money in a single business.[13]

In most cases, individuals have built their families' wealth by recognising a great long-term business opportunity, and by taking equity in that business (i.e. founding capital) for a bargain price. At this point in time they are a pioneer in that they realise the prospects of the business when the broader investment community does not. Hence they obtain their equity cheaply, and if they are correct, may observe that equity multiply over the long term.

For those who cannot build companies, it is at least possible to acquire equity in existing businesses at bargain prices when the broader investment community does not recognise the opportunity, with a view to holding them long term.

Unfortunately, sharemarket investors often find it difficult to think like long-term business owners. Even if they consider themselves 'investors' rather than 'traders', the typical mentality seeks to buy a share in anticipation of a near term rise in price. This is evident in the average holding period of only 15 months for shares listed on the Australian Securities Exchange.[14]

Moreover, the constant flow of information on companies, markets and economies can overwhelm rational thinking. As humans we have great trouble with appropriately weighing the importance of such information and making decisions based upon that, and we are vulnerable to reacting to 'noise'. As Fisher Black put it:

"The whole structure of financial markets depends on relatively liquid markets in the shares of individual firms. Noise trading provides the essential missing ingredient. People who trade on noise are willing to trade even though from an objective point of view they would be better off not trading. Perhaps they think the noise they are trading on is information. Or perhaps they just like to trade. Most of the time, the noise traders as a group will lose money…"[15]

Noise may be one reason for the fickle behaviour of share investors. The distraction caused by noise is evident in regular media commentary, with headlines such as this one – "Buy These 5 Low-Beta Stocks to Counter Market Volatility".[16]

Would a prudent business owner think in terms of 'beta', or jump from one company to another to adjust their risk profile as markets change? Would they sell their business and reinvest the proceeds into bonds because a 'dynamic asset allocation' framework dictates this? It is highly unlikely. But this reflects the gap between how a true business owner thinks, and how the average sharemarket investor thinks.

On the positive side, this is a very helpful feature for investors that are able to shut out the noise and think like business owners. If the above article on beta represents one end of the investor spectrum, the following from Lawrence Cunningham, paraphrasing Warren Buffett, is at the other:

"Long-term investment success depends not on studying betas and maintaining a diversified portfolio, but on recognising that as an investor, one is the owner of a business".[17]

A further suggestion on the business owner mindset, from Buffett himself:

"…we approach the transaction as if we were buying into a private business. When investing, we view ourselves as business analysts – not as market analysts, not as macroeconomic analysts, and not even as security analysts."[18]

The message is simple. Investors should remind themselves that when buying shares they are investing in a business. When buying ASX-listed shares, they should apply the same diligence as they would in considering a private business.

[12] Bailey, M., Financial Review Rich List, https://www.afr.com/rich-list (March 2021)
[13] Harland, D., Australia's 50 Wealthiest Families, https://finh.com/news/australias-50-wealthiest-families/ (2019)
[14] Australian Securities Exchange, as at March 2020

[15] Black, F., Noise, The Journal of Finance vol. XLI, No. 3 (July 1986)
[16] Zacks, N., Buy these 5 Low-Beta Stocks to Counter Market Volatility, https://finance.yahoo.com/news/5-low-beta-stocks-buy-121412546.html (December 2019)
[17] Cunningham, L., The Essays of Warren Buffett, Lessons for Investors and Managers (2000)
[18] Cunningham, L., The Essays of Warren Buffett, Lessons for Investors and Managers (2000)

With this mindset, the investor should think more about the relationship between price and value, and about the risk of overpaying for the company. If you pay more for something than it is worth, you are then reliant on finding a 'greater fool' to buy it from you. If the market price adjusts to fair value before you find your greater fool, then you face a permanent loss of capital. Howard Marks offers some insightful comments on the relationship between price and value, and overpaying as a source of risk:

"Participating when prices are high rather than shying away is the main source of risk. Whereas the theorist thinks return and risk are two separate things, albeit correlated, the value investor thinks of high risk and low prospective return as nothing but two sides of the same coin, both stemming primarily from high prices. Risk arises when markets go so high that prices imply losses rather than the potential rewards they should. Dealing with this risk starts with recognizing it."[19]

Investors that recognise the risk of overpaying stand a better chance of dealing with it than their 'noise-trading' counterparts, and those who are more concerned with optimal calibration of measures such as beta or tracking error.

Some simple questions to ask when considering a share purchase, that may foster a more effective 'business owner' mindset:

Question: If I had to purchase 100% of the business and could not sell it easily, would I buy it at this price?

Question: Do I understand the 'through the cycle' capacity of the business based on a diligent assessment? This will form the basis of what the company is worth.

Question: Why does someone else want to sell this business to me at this price? If the reasons cannot be clearly articulated, there may be only one reason – I am overpaying.

[19] Marks, H., The Most Important Thing: Uncommon Sense for the Thoughtful Investor (2011)

3. AVOID OVERCONFIDENCE AND ACCEPT UNCERTAINTY

Another problem for investors is overconfidence in their ability to interpret information, and their willingness to rely on accepted 'truths'.

Standard risk models tend to assume that we know the expected return for our portfolio, but may not get to experience this return because random events occur over our investment horizon.

One problem with this view of the world is the assumption that the expected return was right in the first place or, to put it more technically, that the method used to estimate the mean produced an unbiased estimate. This section makes the case that for most investors, risk is not volatility, skew or kurtosis, but rather it is the flawed bias in expected returns, which in turn can lead to overpaying for investments and a permanent loss of capital.

To highlight this problem, consider the following hypotheses as factors in expected returns:

a) A reasonable expectation for real long-term average returns is 4-6% p.a.

b) Broad sharemarkets always grow, in real terms, given enough time.

c) A 20 year perspective is enough when investing in the sharemarket.

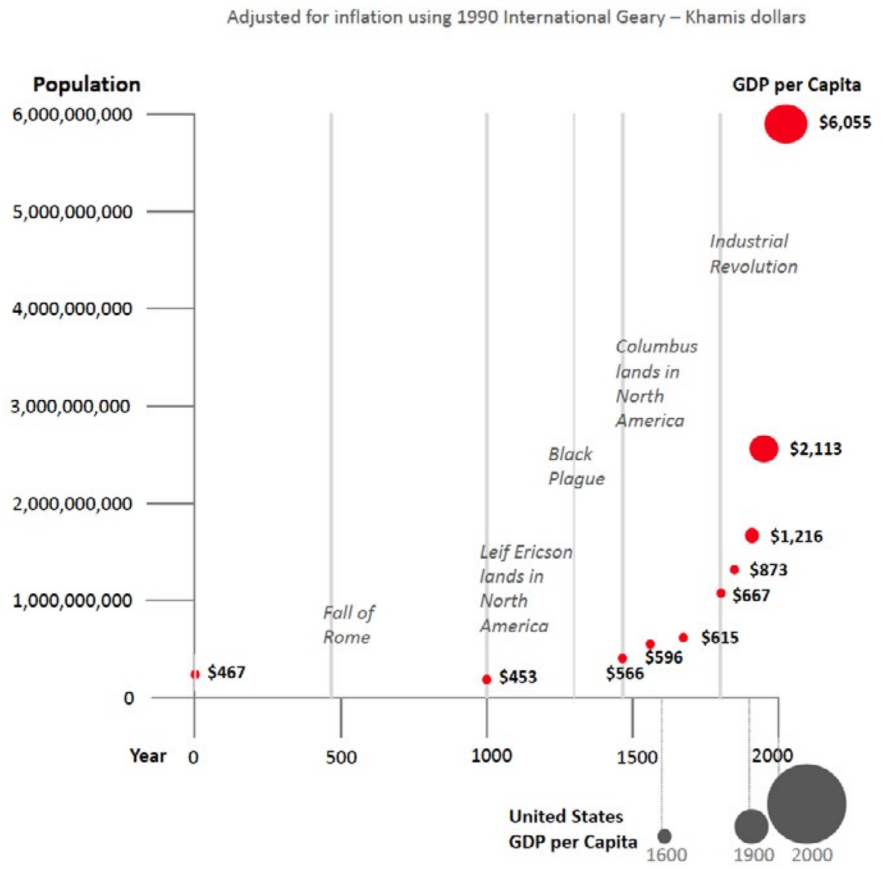
d) Countries with higher economic growth are better places to invest.

e) High growth in an industry is good for investments.

So how realistic are these inputs?

a) A reasonable expectation for real long-term returns is 4-6% p.a.

The chart below shows the world population and GDP per capita over time. There are two remarkable things about this. The first is how little was achieved between 100 AD and 1900 AD (43% growth in GDP per capita in 1,800 years or 0.02% pa). The second is how remarkable the last 100 years have been – GDP per capita has grown 10x since the industrial revolution.



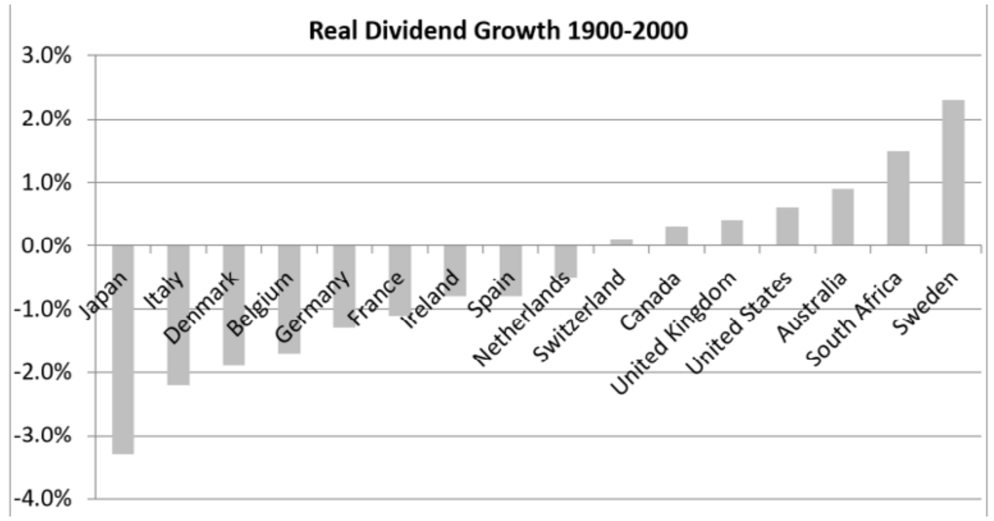
Source: Allan Gray Quarterly Report 2012, based on data from Angus Maddison, University of Gröningen

The awkward thing when it comes to predicting the future is that this chart makes it very hard to assess what is normal. Many of the assumptions in finance are based on studying the last 100 years in the hope that the latter period represents normality, but the truth is that we simply do not know.

In the financial world, you can see problems with compounding returns even at modest rates. For example, if you take $1 in today's money and discount it back 1000 years it would be worth 14.5 pico-cents in money of the day assuming 3% inflation. If we then re-inflate it using a 4% real rate it would be worth 100 quadrillion dollars or 1,400x the market cap of the world sharemarkets.

What this shows is that 4% real may not really be achievable over the very long term.

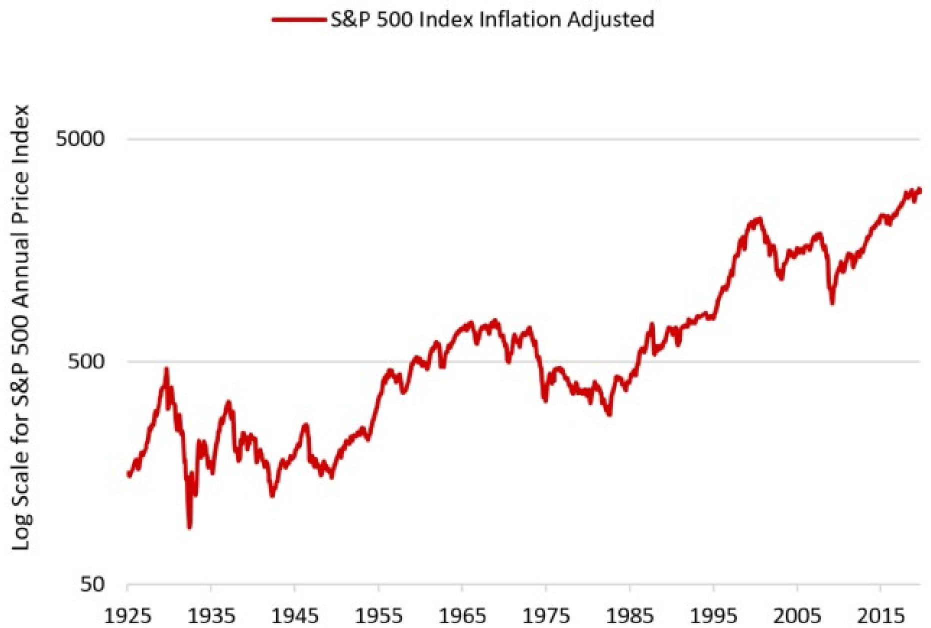
b) Broad sharemarkets always grow, in real terms, given enough time.
Maybe 4% real growth might be a little high, but surely we can expect at least some real growth to compensate for the earnings retained by management teams. Unfortunately this might not be true either. The chart below shows that over the 100 years from 1900, the median real dividend growth rate across 16 developed markets has been less than zero (-0.7%) and this excludes Argentina and Russia, which should have been in the survey but were excluded because investors lost all their capital in these markets.



Source: Dimson, Marsh & Staunton 'Triumph of the Optimists', Princetown University Press, 2002

History shows that real growth is harder to come by than commonly believed.

(c) A 20 year perspective is enough when investing in the sharemarket.
The chart below shows the S&P500 in real terms over time. By eye we can see roughly 3 cycles over this 95 year history with the cycle length being approximately 30 years on average, and sometimes almost 40 years.



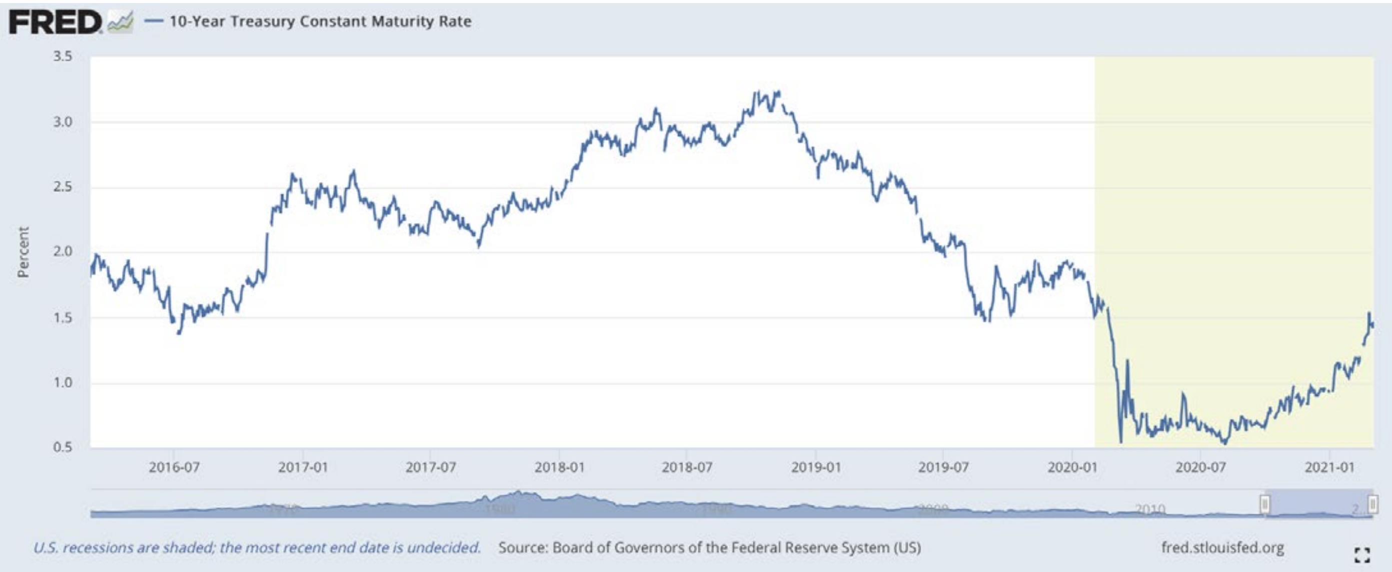
Source: Standard and Poor's, data to Aug 2019

It turns out that 20 years is almost the perfect time period to get investors into a lot of trouble.

For example an investment in equities made in 1950 or 1985 would have been fantastic at the end of a 20-year time scale. Unfortunately investing in equities in 1930, 1965 or 2000 would have been very disappointing over the same time scale.

The same can be said of the bond market. The chart below shows US 10-year bond yields highlighting the fact that bonds were awful from 1960 to 1980 and have been great from 1980 to now.

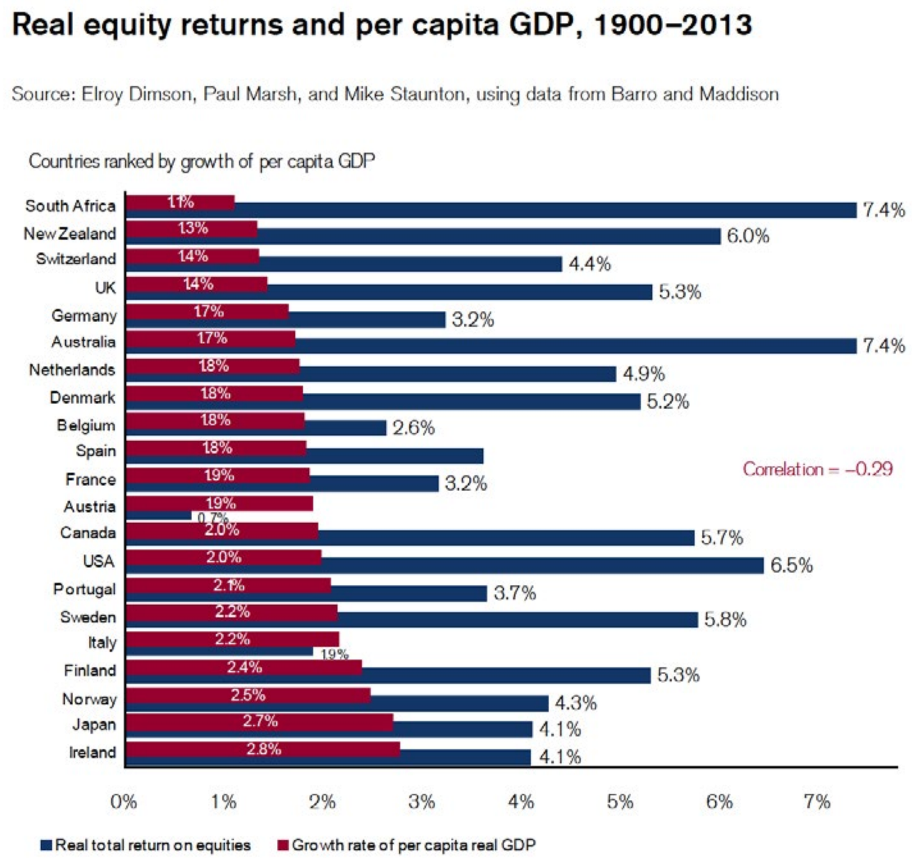
US Long Bond Rates



Source: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, 5 March 2021.

(d) It is better to invest in a country with high economic growth

The graph below shows the relationship between real equity returns and real GDP per capita growth from 1900 to 2013.

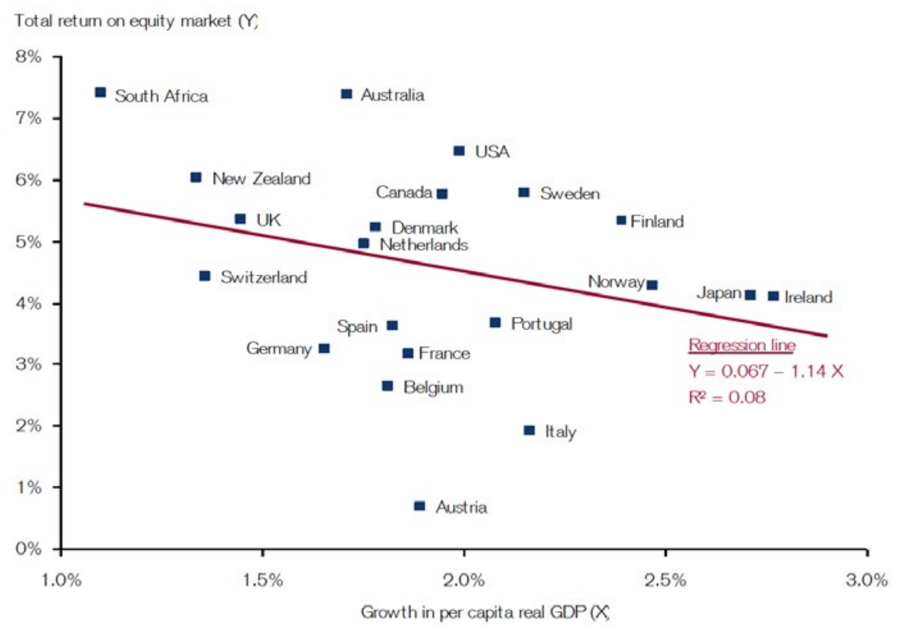


Source: Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002 as set out in 'Credit Suisse Global Investment Returns Yearbook 2014.'

Simply by eye you would conclude that there is not a strong relationship between GDP per capita and real sharemarket performance. Indeed by eye it looks like the countries with the lower equity returns had higher GDP per capita growth and this can be confirmed by observing that the correlation between the two is -0.29.

Real equity returns and growth of per capita GDP, 1900–2013

Source: Elroy Dimson, Paul Marsh, and Mike Staunton; Barro and Maddison. Real per capita GDP growth p.a.



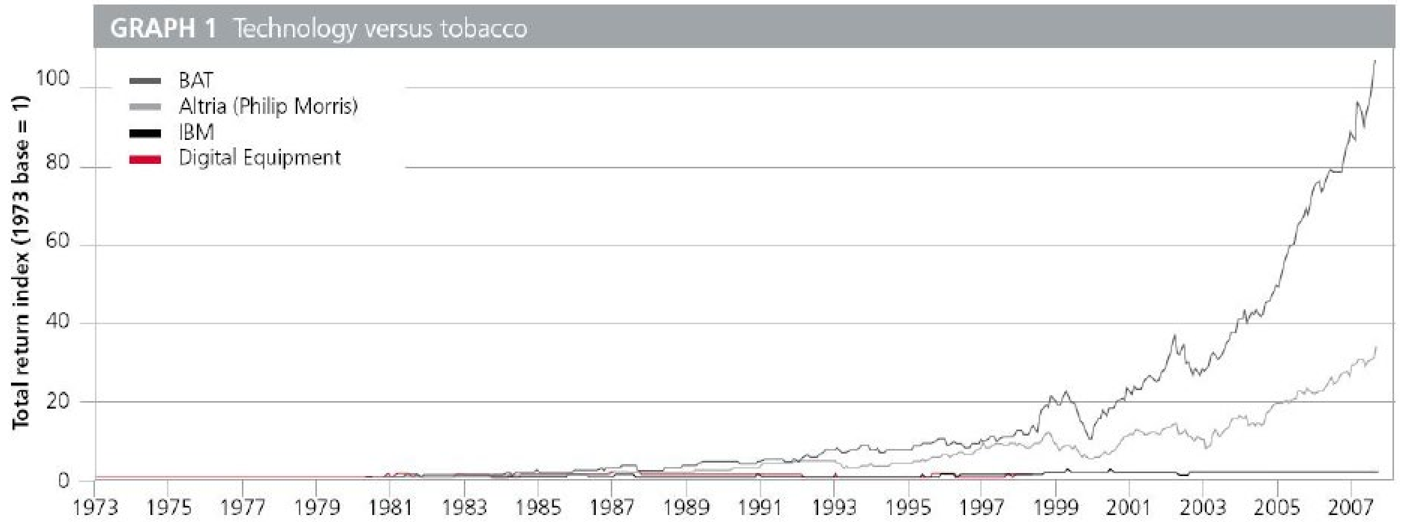
Source: Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002 as set out in 'Credit Suisse Global Investment Returns Yearbook 2014.'

The scatterplot above clearly shows the lack of predictive power held by growth in per capita real GDP. As concluded by the authors, *"it appears that equity investors do not capture benefits as a result of economic advancement, as measured by per capita real GDP."*[20]

One practical implication of these data is that the thesis "invest in emerging markets because GDP per capita is growing fast" is not supported by history.

(e) High growth in an industry is good for investments

To examine the impact on growth and stock performance at the industry level, consider the following thought experiment. Go back to the early-1970s with perfect foresight on industry dynamics. Assume the knowledgethat IT will be a successful, high growth industry and that computers would become ubiquitous. Also assume the knowledge that the tobacco industry would suffer a shrinking market penetration and stifling government regulations. Armed with this perfect foresight buy the biggest two IT stocks of the time (IBM and Digital Equipment) and avoid the two largest Tobacco stocks (BAT and Philip Morris). The graph below shows the benefits that would have accrued from this perfect industry foresight.



Source: Datastream

For the next 40 years, the tobacco stocks have performed so well that you cannot distinguish the IT stocks from the x-axis.

While it seems intuitive that industry dynamics and growth rates should correspond with equity returns, this is not necessarily the case. Yet companies in growing industries are typically more highly valued.

[20] Dimson, E., Marsh, P., and Staunton, M., Credit Suisse Global Investment Returns Yearbook (2014)

[21] Broussard, J., Michayluk, D., Neely, W., The Role of Growth In Long Term Investment Returns, The Journal of Applied Business Research, Vol. 21, No. 1 (2005)

One possible reason why foresight has proved so poor in this regard is that rapidly growing industries attract a rapidly growing list of competitors – IBM did not anticipate the growth in Microsoft and Microsoft did not appreciate the threat posed by Google. In contrast apparently unattractive industries tend to experience reduced competition and hence profit growth is often surprisingly attractive.

What to do about this

In this section, it has been argued that the future is much more uncertain than people believe, and that investors are prone to overconfidence in their assumptions.

Caution against overconfidence can be found in the words of Mark Twain: *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."*

For those willing to acknowledge uncertainty, and their limited ability to predict, there is an opportunity for competitive advantage.

In turn, this requires a willingness to lean against the consensus, which is the focus of the final section of this paper.

4. OPPOSE CONSENSUS

This section turns in more detail to the principle of opposing consensus, why people find it difficult, and why it can provide an advantage.

To stand alone feels vulnerable. From a psychological perspective, there is evidence that as humans we seek social validation to justify our decision making, and we are most receptive to information that confirms and reinforces our existing beliefs.

A crude but powerful example of this behaviour is provided by the 1960s 'sky-gazing' experiment. In this experiment a man stopped on a busy New York sidewalk and gazed up to the sky. The intention was to assess the effect on passers-by. Only about four percent of passers-by joined the man in looking up.

The interesting development came when the number of initial planted up-lookers was increased. With five men looking up at nothing, 18 percent of pedestrians joined them. With a starting group of 15 sky-gazers, now 40 percent of passers-by stopped and joined them in looking skyward.[22]

As Robert Cialdini explains it: *"One fundamental way that we decide what to do in a situation is to look to what others are doing or have done there. If many individuals have decided in favour of a particular idea, we are more likely to follow, because we perceive the idea to be more correct, more valid."*

Another influencing factor highlighted by Cialdini is authority. Specifically, it is the perception of authority that matters, regardless of whether there is a genuine basis for that authority.[23]

So along with social validation, authority can be a powerful influencer. In some situations, these shortcuts may be an effective aid to decision making.

But when it comes to investments, the influence of social validation and authority can lead investors into trouble. Conversely, shunning the consensus opinion of 'experts', can provide a distinct advantage.

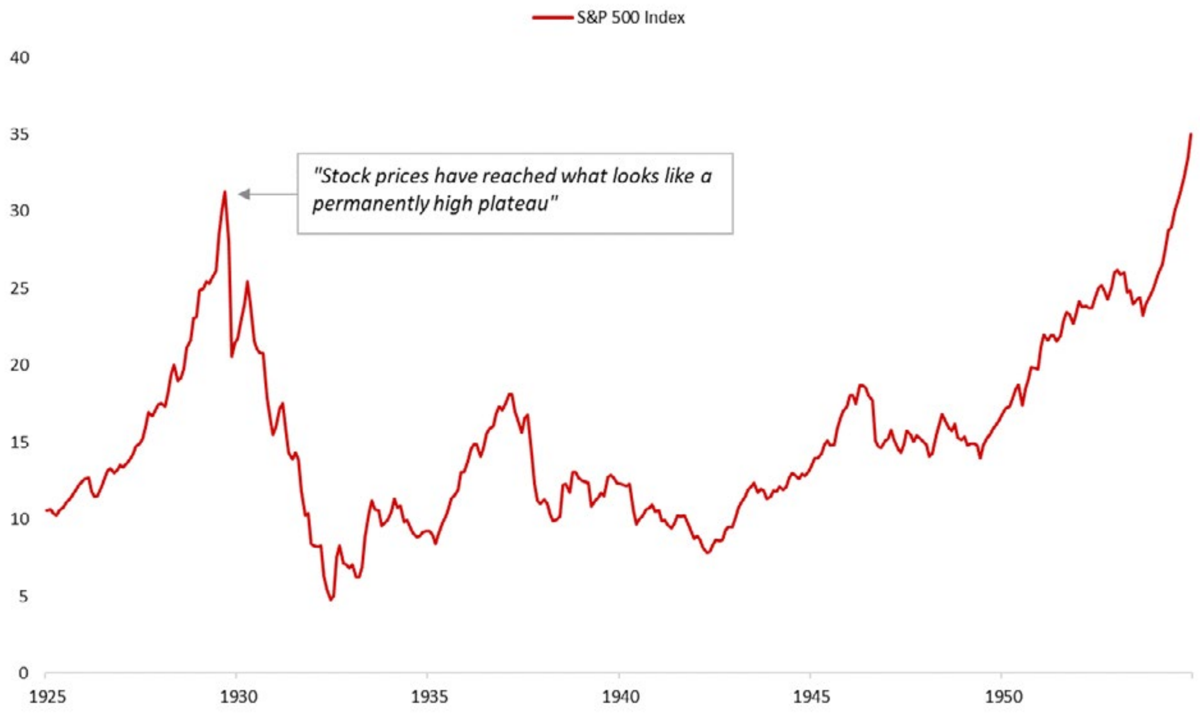
But why is this so in the investment world, in contrast to other fields?

If you want to build a bridge and 99% of structural engineering reports tell you the bridge is likely to fall down, you would be well advised not to proceed with the design. Similarly, few of us would do something that is explicitly against the advice of our lawyer. One might expect this to be true for investment advice, given the high salaries paid in the industry and the many bright minds it attracts.

Looking at the record suggests otherwise. First, an example of just how wrong authoritative 'experts' can be.

[22] Cialdini, R., Influence: The Psychology of Persuasion (1984)
[23] Cialdini, R., Influence: The Psychology of Persuasion (1984)

In October 1929, Irving Fisher was a respected economist, Yale professor and adviser to several investment trusts when he made his infamous prediction....[24]



Data Source: Standard and Poor's, data to Aug 2019

At the time of this comment, the US market was about to commence its devastating collapse of around 90% in slightly less than three years. It didn't regain its 1929 peak until 1954 – 25 years later.

With the benefit of hindsight, this may seem an extreme example of overconfidence. But for some reason, economists continue forecasting eventualities that are just as difficult to contend with.

Adam Shaw, writing for the Guardian, neatly summarises the findings of IMF researchers in relation to economist's predictions.

"Prakash Loungani at the IMF analysed the accuracy of economic forecasters and found something remarkable and worrying. "The record of failure to predict recessions is virtually unblemished," he said.

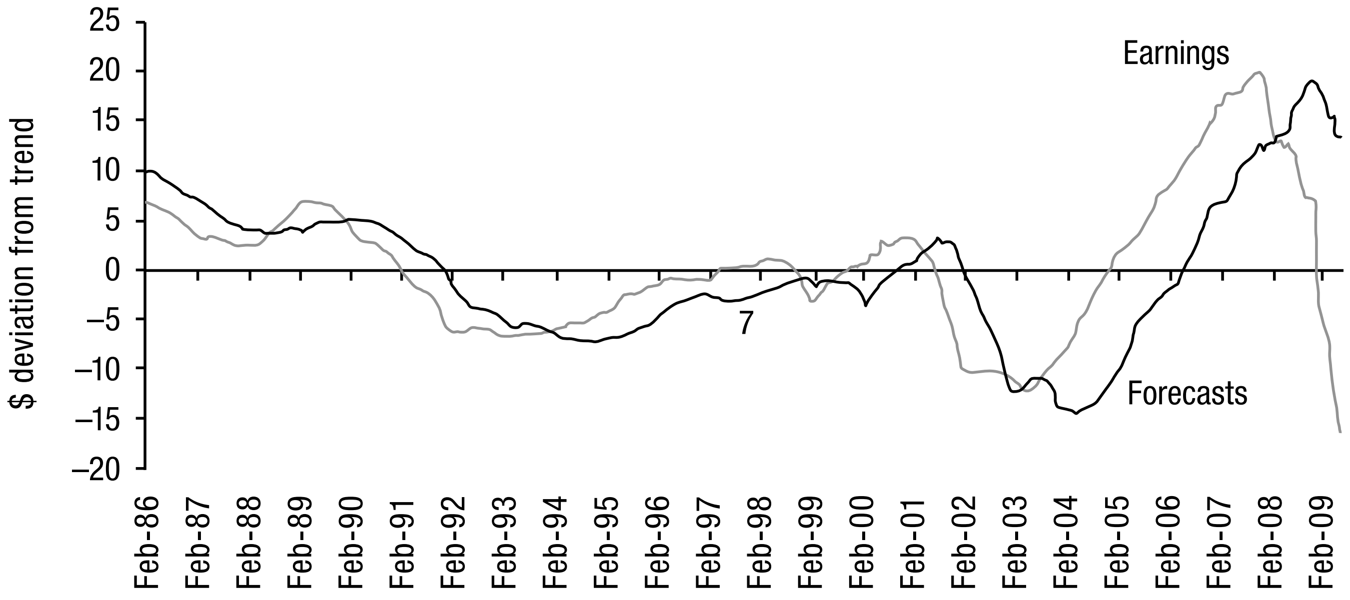
His analysis revealed that economists had failed to predict 148 of the past 150 recessions. Part of the problem, he said, was that there wasn't much of a reputational gain to be had by predicting a recession others had missed. If you disagreed with the consensus, you would be met with scepticism. The downside of getting it wrong was more personally damaging than the upside of getting it right."[25]

Indeed, based on this evidence, it seems the most effective strategy is to identify situations where there is broad agreement amongst the experts, then bet against them.

[24] Galbraith, J. K., The Great Crash: 1929 (1954)
[25] Shaw, A., Why economic forecasting has always been a flawed science, https://www.theguardian.com/money/2017/sep/02/economic-forecasting-flawed-science-data (2 September 2017)
https://www.theguardian.com/money/2017/sep/02/economic-forecasting-flawed-science-data

Moving on from economists to sharemarket analysts, the chart below shows detrended operating earnings for companies in the S&P 500 Index, alongside aggregate analyst forecasts for those earnings over time.

James Montier published this chart at Societe Generale, and later at GMO. Montier made two striking observations about this chart. Firstly, analysts are exceptionally good at one thing – telling you what has just happened and extrapolating that into the future. Secondly, they display common behavioural biases such as 'anchoring' and 'confirmation bias'. In other words, they are slow to acknowledge their error, and even then they adjust their forecasts very slowly.[26]



Source: James Montier, GMO[27]

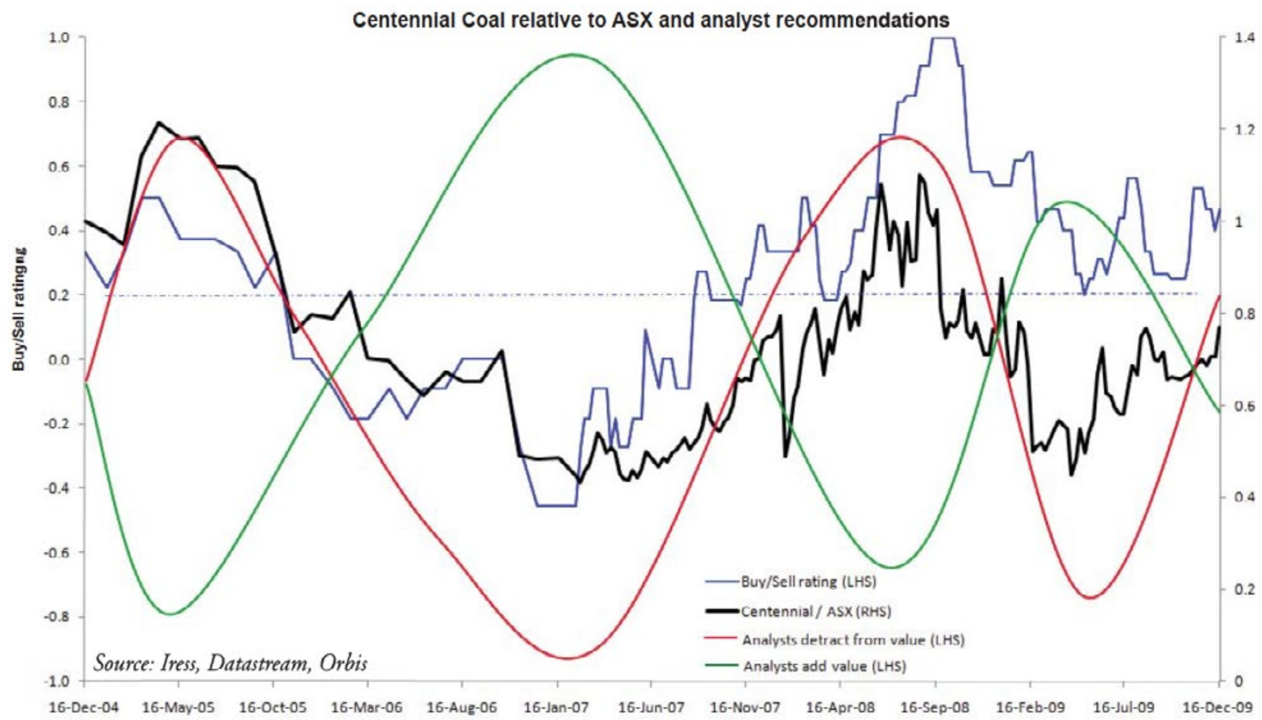
Again we see evidence that it is better to take a contrarian stance and oppose the consensus.

26 Montier, J., Behavioural Investing, A Practitioner's Guide to Applying Behavioural Finance (2007) and The Little Book of Behavioural Investing, How Not to Be Your Own Worst Enemy (2010)
27 Montier, J., The Little Book of Behavioural Investing, How Not to Be Your Own Worst Enemy (2010)

Taking this one step further to the company specific level, the following analysis from December 2009 offers a case study on the value of consensus expert opinion.[28]

The graph shows Centennial Coal's share price relative to that of the sharemarket. Centennial had some dramatic periods of out- and under-performance allowing ample opportunity for analysts to add value.

To see what the 'average' analyst thought of Centennial over time, the study took the number of 'Buy' recommendations on the stock, subtracted the number of 'Sell' recommendations and divided the answer by the total number of analysts covering the share to arrive at a 'Buy/Sell rating'. A Buy/Sell rating of zero thus means that the number of analysts that like and dislike the share is the same, while a reading of 0.5 could indicate that there were six out of eight analysts recommending a 'Buy' and two recommending a 'Sell': (6-2)/8 = 0.5.

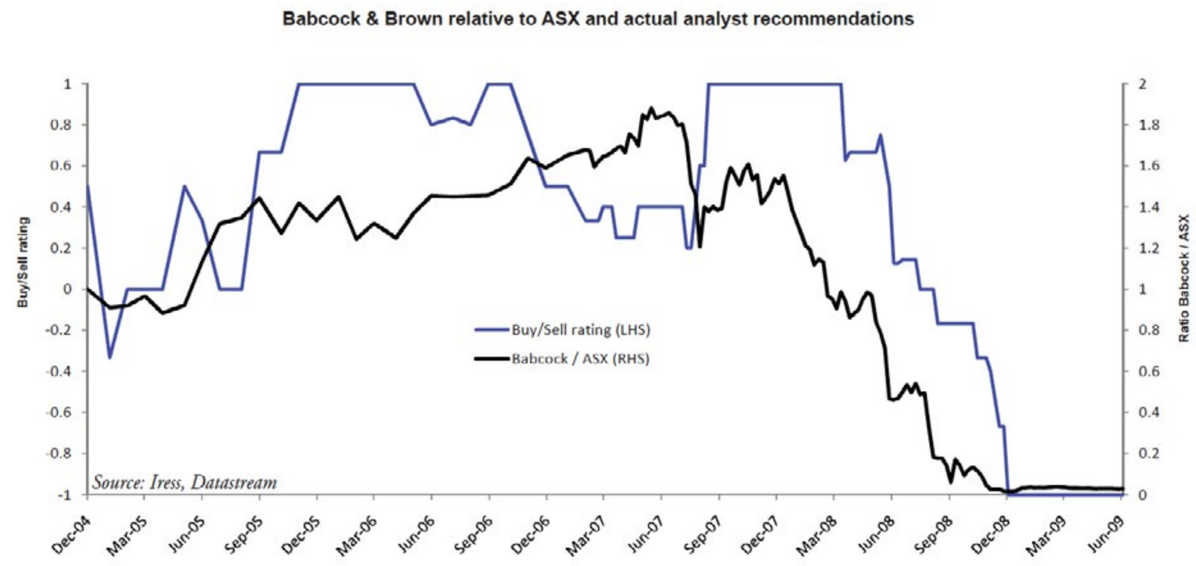


Source: Iress, Datastream, Allan Gray

If analysts were skilful, the average recommendation should look something like the green line with a positive recommendation when the share offered great value (e.g. 2007) and a net sell bias around major peaks (early 2005 and mid 2008). If analysts were worse than random at predicting what would happen, you would expect to see something like the red line with Sell recommendations dominating near troughs and Buys dominating near peaks.

What really happened is shown by the solid blue line in the graph. This average Buy/Sell recommendation is more correlated with the red line than the green line. In the case of Centennial, you would have done best by waiting for the analysts to reach consensus, and then doing exactly the opposite.

Another test may be to see whether analyst recommendations provided any warnings about impending disasters. Few Australian companies have had a bigger fall from grace than Babcock & Brown (B&B) in 2008. It is interesting to see how many analysts gave investors a fair warning about the company.



Source: Iress, Datastream

Again the answer is not exactly heart-warming. From the middle of 2007 until April 2008, the period when the first cracks in B&B started to appear, each of the nine analysts on record had the company as a 'Buy'. By the time the first 'brave' soul changed their recommendation, the stock had already lost more than half of its value. The majority of analysts did not warn investors to sell until B&B was down by more than 90% off its peak and within a few months of being suspended.

In part, it is the nature of market pricing that is the problem. The laws governing engineering problems like the example of building a bridge are fixed by nature. But the pricing of a share is not fixed by any external laws. The price of a share is that point where the buyers and sellers at any moment are in balance, based on their respective future expectations. Substantial price movements will only occur, therefore, when the future differs from prior expectations. As a result, the greater the consensus opinion amongst analysts and investors, the less useful this opinion becomes in the event it is proved correct.

But why does the expert consensus tend to be wrong, rather than merely random?

In answering this question, several contributing factors can be identified from the earlier discussion.

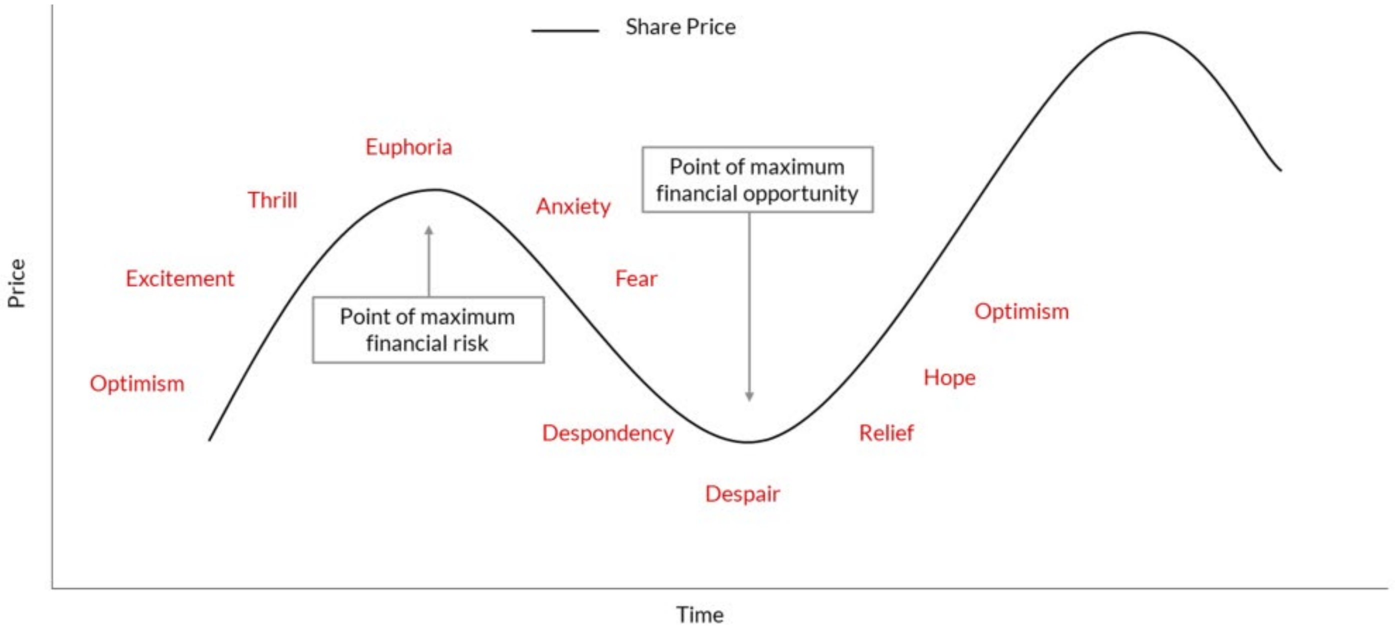
Firstly, career risk can lead analysts to fear being wrong alone.

Secondly, professional investors and analysts are subject to the same human decision making influences as everyone else.

Furthermore, for analysts and indeed for all investors, behavioural biases such as 'anchoring' and 'confirmation bias' cause them to be slow to change their minds.

For these reasons, consensus opinion tends to overpay for popular investment ideas and underpay for unpopular ideas.

[28] Allan Gray Australia (formerly Orbis Investment Management Australia), Quarterly Report (December 2009)



Source: Allan Gray Australia

Both Warren Buffett[29] and Howard Marks have noted that, contrary to the common perception, the risk of an investment tends to move in the same direction as its price, while the prospective return moves in the opposite direction. From Howard Marks:

"Risk arises as investor behaviour alters the market. Investors bid up assets, accelerating into the present appreciation that otherwise would have occurred in the future, and thus lowering prospective returns. And as their psychology strengthens and they become bolder and less worried, investors cease to demand adequate risk premiums. The ultimate irony lies in the fact that the reward for taking incremental risk shrinks as more people move to take it."[30]

So from a risk perspective, the consensus opinion tends to perceive risk as lower when prices are higher, and risk as higher when prices are lower. This is why a contrarian approach can be difficult to implement from a behavioural perspective, but also why it can provide a competitive advantage from an investment perspective.

CONCLUSION

This paper has suggested that for an investment approach to add value sustainably it must involve strategy or behaviour that is not easy to replicate. To demonstrate this, four key behaviours have been identified. It has been argued that each of these plays an important role in investment outcomes, but also that investors find it difficult to implement these behaviours to their benefit. Implementation is difficult due to investor incentives and psychology.

Alignment of interest is important in ensuring that decision making focuses on investment outcomes, rather than being driven by the self-interest of intermediaries.

Thinking like a business owner is a simple concept, but one that is often lost due to short term profit seeking, and investor susceptibility to 'noise'. As a result, the practice of rigorous valuation and the risk of overpaying do not receive appropriate attention.

Commonly held beliefs and intuitive assumptions often lead to overconfidence and an underestimation of the level of uncertainty. Such behaviour can be difficult to avoid as it 'feels right'. It also leads to opportunity for those investors able to embrace uncertainty.

The last section argued that opposing consensus can be psychologically challenging and feels uncomfortable to many investors. The relationship between prospective return, risk, and the popularity of an investment can be counterintuitive to investor psychology.

Ironically, it is the unpopular and uncomfortable that can make contrarian investing such a rewarding and sustainable strategy.

[29] Cunningham, L., The Essays of Warren Buffett, Lessons for Investors and Managers (2000)
[30] Marks, H., The Most Important Thing: Uncommon Sense for the Thoughtful Investor (2011)

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