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The lost art of investing

'We don't know how to buy stocks by metrics. We know that Burlington Northern will have a competitive advantage in years; we don't know what the heck Apple will have. You have to understand the company and its competitive positions. That's not disclosed by the maths.' - **Charlie Munger at the 2013 Berkshire Hathaway AGM**

Many investors today apply a 'value' approach to investing. Typically, this approach involves detailed analysis of companies in order to ascribe a fair value to those businesses. When the market price of a security differs materially from the estimated fair value, an opportunity to buy or sell exists. This largely numerical approach to value investing has become *de rigueur*.

While this approach may bring comfort to potential investors that they have 'ticked the boxes' in terms of manager selection and is probably a requirement for success, we would argue it is unlikely to be sufficient. Given that investment performance is a zero-sum game and that long-term winners can only differentiate themselves by doing things differently, this garden variety value style may well have become consensus investing and therefore doomed to fail.
In our opinion, there are subtle difference that distinguish stand-out valuation-based managers from the run-of-the-mill. These differences stem from two broad areas: organisational factors and qualitative mastery.

Organisational factors

There is strong evidence that firms that organise themselves sensibly have the best chance of success. Independent, owner-managed firms that focus exclusively on investment management and where the principals co-invest materially alongside their clients (preferably on the same, reasonable terms) are best structured to deliver the goods. The reason for this is that the appropriate business structures allow firms to better withstand the manifold pressures that come with inevitable periods of underperformance. Fortunately, these factors are relatively easy to identify upfront and tend to be quite constant.

Qualitative mastery or the 'art' of investing

Although value investing is commonly thought to be a quantitative endeavour, this is not really the case. Successful investment decisions cannot be made on metrics alone. To excel, mastery of a range of qualitative areas is also required. These can be difficult to define, but typically include the following examples.

The ability to see the 'value' of 'growth'

It is more difficult to analyse a company where much of the value will be derived from future growth compared to a company where much of the value is currently evident on the balance sheet. The average investor may put these potentially faster growing companies on the 'too hard' pile too quickly as at first glance they are likely to appear dear relative to the rest of the market. This can result in missed opportunities. The average investor is also more likely to get stuck in value-traps; buying shares in 'cheap' companies that are cheap for a reason, and therefore remain so. Great investors can strike a balance between value today and value in the future because they have the ability to recognise sustainable growth potential and incorporate this into their valuations. This requires a very particular mind-set for investors that naturally prefer to select stocks that currently appear cheap.

The ability to recognise quality and sit tight

Great investors do not sell their best quality ideas just because the price has gone up, especially if they have to deploy the proceeds into a lower quality although theoretically cheaper idea. Too often the highest quality ideas are sold too early, and don't provide the expected cheaper entry point down the line. Great investors have the ability to override some of their 'value bias' because they understand that great businesses don't come around too often. They have trained themselves to apparently 'overpay' for such businesses because they have appropriately valued the ability of great companies to compound internally and do the heavy-lifting for them over many years to come. The dearth of quality companies in South Africa makes this potentially a more important factor for local fund managers. Low portfolio turnover could be a clue that you are on to a good thing.

Flexibility vs. rigidity of thought

Good investors are naturally contrarian but not dogmatically so. Some value investors fall into the trap of believing that they always have to be different and that their peers are generally 'dumb', 'lazy' or 'just don't get it'. We would argue it does not always pay to be contrarian; managers need to recognise that they, rather than the market, may have got it wrong. Aligned to this is the ability of the best investors to recognise and act on their mistakes earlier than others.

Great investors also tend to be flexible in their thinking. They are more comfortable dealing with uncertainty than those who require precision. They attack problems from many angles and have the ability to develop effective mental models to help their understanding of a particular situation.

Ability to understand the current investing environment

Value investors often like to naysay top down (macro) input. Although it is true that accurately forecasting economic variables is pretty much impossible (there exists little evidence of it being done repeatedly and profitably), analysis of the investment landscape can help investors avoid mistakes. For example, during the credit crisis, many large global banks fell precipitously and appeared cheap on traditional measures such as price to net asset value (P/NAV). These securities became a natural hunting ground for value investors, who ended up with poor returns because they had not adequately factored-in the increased risks associated with these banks due to their price falls. Government intervention and a raft of capital raisings left the banks' capital base decimated. An analysis of the risks associated with the loss of confidence in banks may have helped mitigate this risk in the portfolio.

Stock level risk management vs. portfolio level risk management

It is common for value managers to control portfolio risk by managing single stock risk. They argue that if they invest in only the cheapest shares in their universe, then a portfolio of such shares is well constructed from a risk perspective. However, this method of portfolio construction can introduce certain biases and result in unbalanced portfolios. This is because shares tend to appear cheap or expensive in cohorts. These portfolios can therefore be negatively impacted from unforeseen negative developments in the grouping of shares included (errors of commission) or unforeseen positive developments in the shares avoided (errors of omission). The best fund managers operate in a world of multiple potential outcomes. They are able to construct portfolios that will produce reasonable returns in most scenarios rather than those that will produce excellent (or dire) returns in any particular scenario.

The stand-out managers of the future will be those that have organised their businesses sensibly and have a material vested interest in their clients doing well. They will also have the ability to look 'beyond the numbers' to strike an appropriate balance between cheapness, growth, quality and risk in their portfolios.