

Mind Matters

The tao of investing: the ten tenets of my investment creed

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Many times over the years I have been asked how I would approach investing. This note attempts to codify my beliefs (and provide some evidence for them). However, before embarking upon a journey into my investment creed, it is worthwhile asking a question that doesn't get asked often enough – What is the aim of investing? The answer to this question drives everything that follows. I feel that Sir John Templeton put it best when he said “For all long-term investors, there is only one objective – maximum total returns after taxes”. Nothing else matters. The question becomes, how should we invest to deliver this objective?

■ **Tenet I – Value, value, value.** Value investing is the only safety first approach I have come across. By putting the margin of safety at the heart of the process, the value approach minimises the risk of overpaying for the hope of growth.

■ **Tenet II – Be contrarian.** Sir John Templeton observed that “It is impossible to produce superior performance unless you do something different from the majority”.

■ **Tenet III – Be patient.** Patience is integral to a value approach on many levels, from waiting for the fat pitch, to dealing with the value managers' curse of being too early.

■ **Tenet IV – Be unconstrained.** While pigeon-holing and labelling are fashionable, I am far from convinced that they aid investment. Surely I should be free to exploit value opportunities wherever they may occur.

■ **Tenet V – Don't forecast.** We have to find a better way of investing than relying upon our seriously flawed ability to soothsay.

■ **Tenet VI – Cycles matter.** As Howard Marks puts it, we can't predict but we can prepare. An awareness of the economic, credit and sentiment cycles can help with investment.

■ **Tenet VII – History matters.** The four most dangerous words in investing are “This time is different.” A knowledge of history and context can help avoid repeating the blunders of the past.

■ **Tenet VIII – Be sceptical.** One of my heroes said “Blind faith in anything will get you killed”. Learning to question what you are told and developing critical thinking skills are vital to long-term success and survival.

■ **Tenet IX – Be top-down and bottom-up.** One of the key lessons from the last year is that both top-down and bottom-up viewpoints matter. Neither has a monopoly on insight.

■ **Tenet X – Treat your clients as you would treat yourself.** Surely the ultimate test of any investment is: would I be willing to invest with my own money?

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The tao of investing: the ten tenets of my investment creed

Over the years, I have been asked many times how I would approach investment. Until today I have always shied away from answering directly. However, I feel it is time to codify my investment beliefs. This note represents my attempt to set out my own personal investment creed.

However, before we embark upon this journey into the murky world of my beliefs, we need to frame the question. Essentially this amounts to asking: what is the aim of investing?

The aim of investing

This has always struck me as a question that could do with being asked a great deal more than it actually is. From my perspective, Sir John Templeton put it best “For all long-term investors, there is only one objective – maximum total returns after taxes”, or as Keynes put it “The ideal policy... is where it is earning a respectable rate of interest on its funds, while securing at the same time that its risk of really serious depreciation in capital value is at a minimum”.

These definitions pretty much say it all. Of course, in today’s world of fund supermarkets and the dominance of the relative performance derby, such simple concepts as total real return don’t often feature in investment mandates (apart from hedge funds, of course). But surely, ultimately this is what any fund should strive to achieve.

Viewing the world in these terms also prevents us from falling into the modern finance obsession of alpha and beta. As I have written before (see Chapter 35 of Behavioural Investing), I reject CAPM on both empirical and theoretical grounds. Once CAPM is thrown out then concepts such as alpha and beta become meaningless, and one can focus on return generation in its own right rather than the distraction of decomposition.

Having set out our investment objective, it is time to turn to the philosophy of how this might be achieved. Below you will find my ten tenets of investment. These represent my beliefs (and in some cases some evidence) on the way in which an investment operation should be run.

Tenet I – Value, value, value

At the very heart of the approach I follow is the belief that the price I pay for an investment determines the likely return. No asset is so good as to be immune from the possibility of overvaluation, and few assets are so bad as to be exempt from the possibility of undervaluation. Thus an asset can be an investment at one price but not at another.

The separation between value and price is key, thus this approach inherently rejects market efficiency (in which price and value are equal). As Warren Buffett said, “Price is what you pay, value is what you get”. However, the aim is obviously not to buy at fair value, because that will simply generate an average return.

Rather, investments should be purchased with a margin of safety. Any estimate of intrinsic value will only prove to be correct via the intervention of luck. Hence, buying only when a large discount to that estimate is available offers protection against being wrong. As Ben Graham

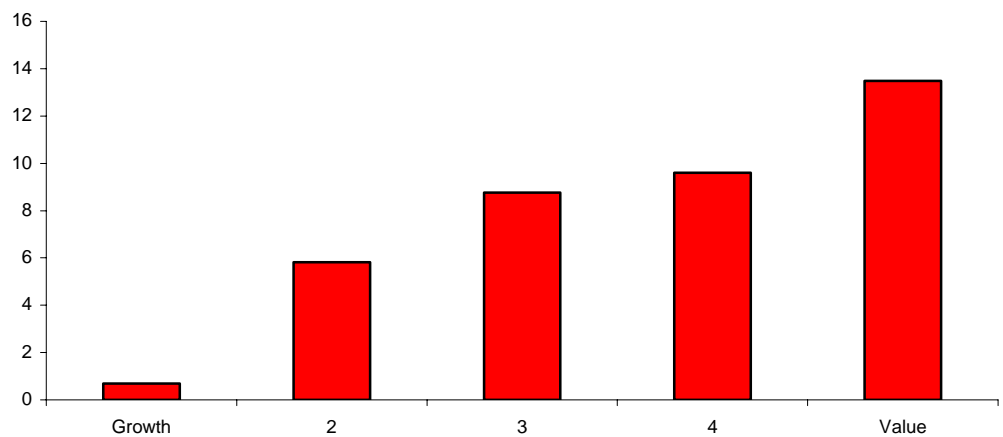
said, the margin of safety is “available for absorbing the effect of miscalculations or worse than average luck”.

Value investing is the only form of ‘safety first’ investing I have come across. It places risk management at the very heart of the approach. Of course, when I talk of risk management I am not talking of the modern pseudoscience so beloved by quants, but rather the “permanent loss of capital”. Value investors implicitly try to mitigate ‘value risk’ (the risk of paying too much for something), and spend their time trying to figure out the degree of business and balance sheet risk they are faced with (see [Mind Matters, 27 January 2009](#) for more on this).

I would also suggest that value is an absolute concept, not a relative one. Arguing that a stock is attractive just because it is cheaper than its peers seems to be a route to disaster to me. The ratio of price to intrinsic value is the only measure that should matter.

This isn’t the place for a full-scale review of the empirics that show the advantage offered by following a value approach. But to provide some limited evidence, the three charts below show the role of value in three different contexts. The first chart shows the performance of an unconstrained global value approach to stock selection (this is an update of work I presented in [Mind Matters, 16 September 2008](#)). It clearly shows the advantage a value perspective brings to an investor.

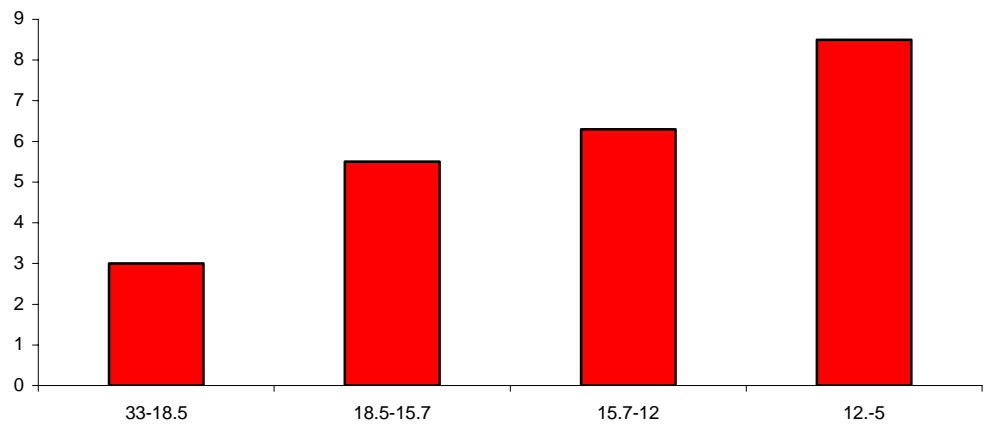
Global unconstrained value investing works! (1985-2008, % p.a.)



Source SG Global Strategy Research

However, asset allocators shouldn’t ignore value either. The chart below shows the advantages of deploying capital when overall market valuations are cheap. It shows the real ten-year returns based around the purchase point defined in terms of Graham and Dodd P/Es (current price over ten-year moving average earnings). Clearly value has a role to play in asset allocation as well as in stock selection.

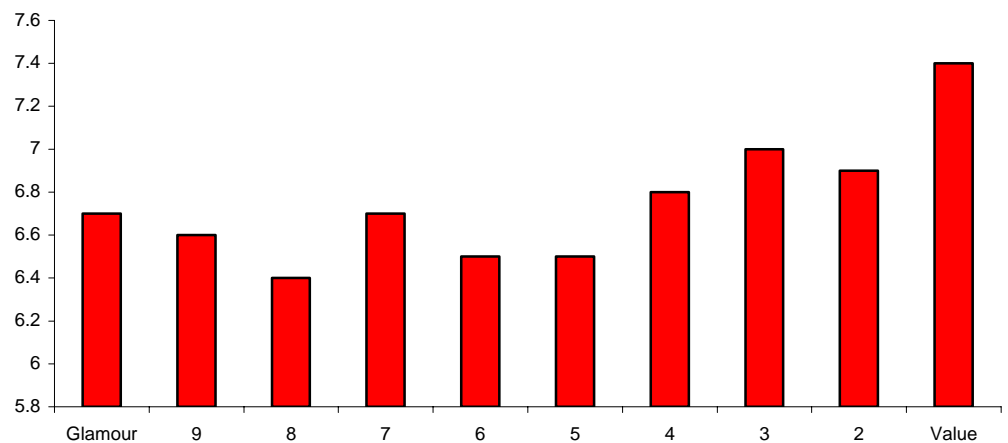
Real returns over the subsequent decade by purchase G&D P/E (% p.a.) (1871-2008)



Source SG Global Strategy Research

Fixed-income investors would be foolish to ignore value as well. My friends at the Brandes Institute performed an intriguing study last year on the performance of glamour and value bonds (defined as bonds from companies with high and low price to book ratios, respectively). They find that the bonds of value companies do considerably better than the bonds of glamour companies! So yet again the power of value shines through.

Average annualised 3-year bond returns, ranked by P/B decile (1990-2007)



Source: Brandes Institute

Tenet II - Be contrarian

As Keynes opined “The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone agreed about its merit, the investment is inevitably too dear and therefore unattractive.” Or as Sir John Templeton observed “It is impossible to produce superior performance unless you do something different from the majority.”

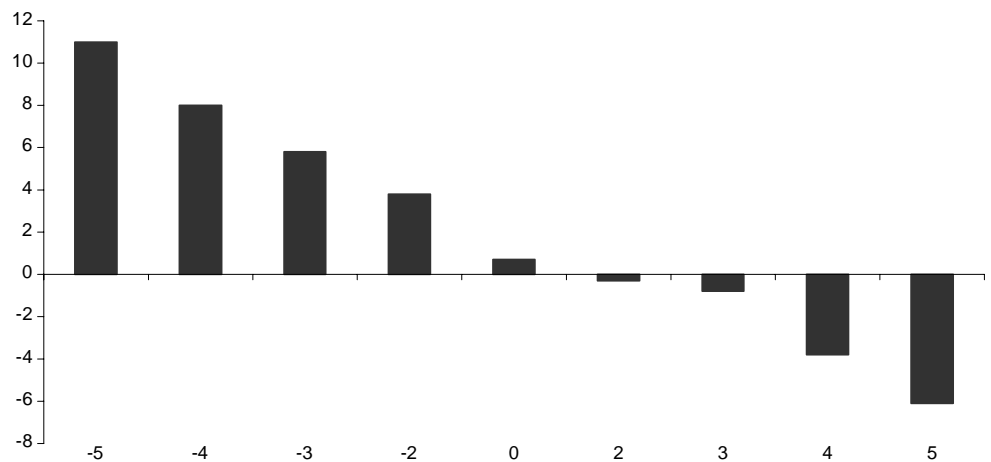
Following a value-orientated approach will almost certainly lead you to a contrarian stance, because you are generally buying the unloved assets and selling the market’s darlings.

Rather than worry over the latest survey of opinion, I prefer to infer the consensus from asset prices. The reason for this preference is essentially misanthropy. Just as House, the eponymous anti-hero of the US TV drama, refuses to talk to patients because they lie, I am generally mistrustful of survey responses. To my mind all too often they represent where people like to be allocated, rather than actually where they are positioned.

The power of a contrarian approach has been demonstrated by the work of Dasgupta et al¹. They show that the stocks institutional fund managers are busy buying are outperformed by the stocks they are busy selling! They examined US fund managers' filings from 1983-2004. Each quarter, stocks are assigned to different portfolios conditional upon the persistence of institutional net trades (that is the number of consecutive quarters for which a net buy or a net sell is recorded). A persistence measure of -5 includes all stocks that have been sold for at least five quarters, and a persistence measure of 0 shows stocks that have been bought or sold in the current period.

The chart below shows the market-adjusted future returns for each persistence portfolio on a two-year time horizon. Even a cursory glance reveals the negative relationship between returns and institutional buying and selling. Over a two-year time horizon there is a 17% return difference - the stocks that the institutions sold most outperforming the market by around 11%, and the stocks they purchased most underperforming by 6%!

Abnormal returns over two years by buying persistence category (%)



Source: Dasgupta et al

Dasgupta et al also noted several characteristics of the stocks that fund managers seem to buy with high persistence. Such stocks tend to be liquid, growth (low book to market) stocks with high momentum. Conversely, those that inhabit the selling portfolio are generally less liquid, value stocks with poor past returns.

One final aspect of Dasgupta et al's work is noteworthy. They estimated a measure of how likely each manager is to herd (or conform, if you prefer). They called this measure the sheep index. They concluded "We find that about three-quarters of institutions display conformist

¹ Dasgupta, Prat and Verardo (2006) The Price of Conformism

patterns when faced with high-persistence stocks... our measure of conformism is pervasive... with the majority of managers displaying a positive sheep value". As Ben Graham said, it requires "considerable will power to keep from following the crowd".

Tenet III - Be patient

Patience is integral to the value approach on many levels. As Ben Graham wrote "undervaluations caused by neglect or prejudice may persist for an inconveniently long time, and the same applies to inflated prices caused by over-enthusiasm or artificial stimulants".

Whenever a position is put on, one can never be sure whether it will work or not. Buying cheap stocks helps generate long-run returns, but tells us nothing about the short-term prospects. Cheap stocks can always get cheaper, and expensive stocks can always get more expensive (in the short term).

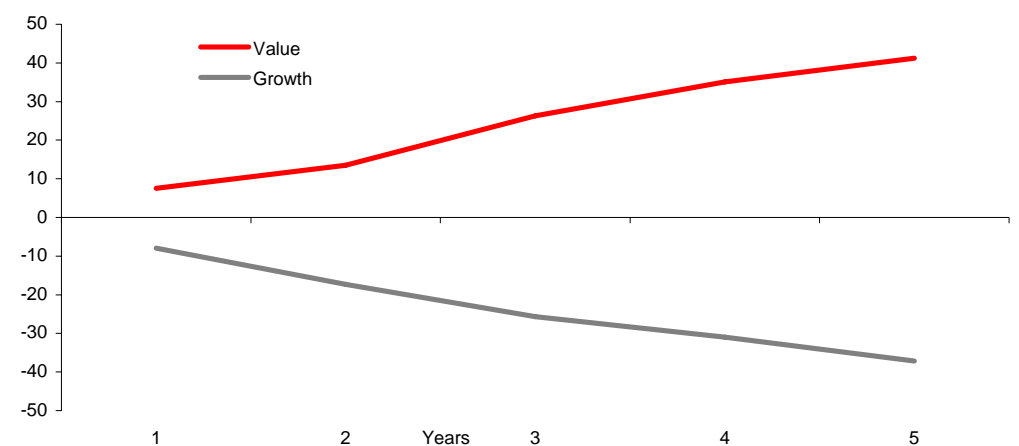
Thus patience is required. At the stock level, a value situation can lead to one of three possible outcomes:

- 1) A stock may re-rate as the market corrects the underpricing
- 2) The stock may stay depressed, but potentially generate a return through higher dividend payments
- 3) The stock may never recover (aka value traps)

So patience is a prerequisite for value managers as long as we are dealing with the first two types of stocks, and a key problem when it comes to the third type of stock. The chart below shows the need for patience when it comes to global value investing.

The value strategy tends to outperform the market by around 7% in the first year. If you hold for another 12 months, an additional 6% is added to the return. However, holding for longer periods really creates opportunity. In the third year an amazing 12% outperformance of the market is recorded, followed by another 8% in the fourth year.

Patience is a virtue: cumulative excess returns over various holding periods

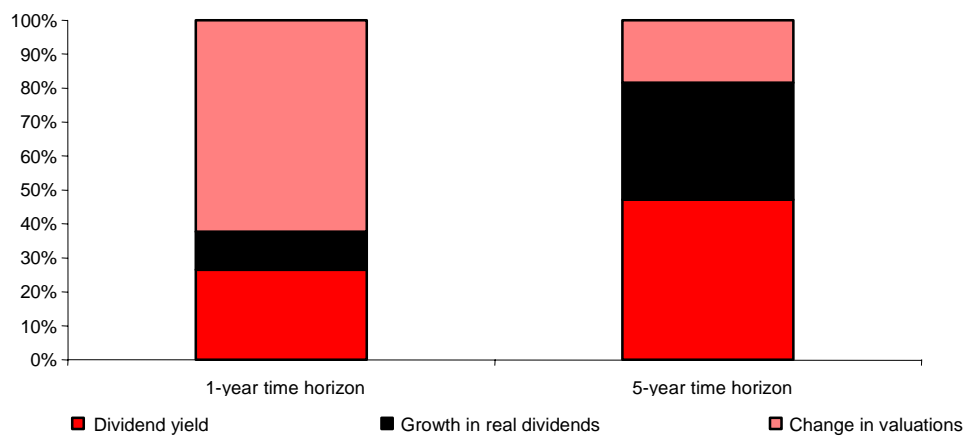


Source SG Global Strategy Research

This receives practical support when one examines the average holding period of long-term successful value managers; their average holding period is around 5 years. A marked contrast to the churn and burn of the average mutual fund.

A long time horizon makes sense from the perspective of the drivers of returns as well. For instance, on a one-year view, 60% of your total return comes through changes in valuation (effectively random fluctuations in prices about which I know nothing). However, as we extend the time horizon, so the things I, as a fundamental investor, am meant to understand start to matter much more. For instance, over a five-year horizon, some 80% of the total real return is generated through the price I pay and the growth in the underlying business.

Contribution to total real return depends on your time horizon – US data since 1871

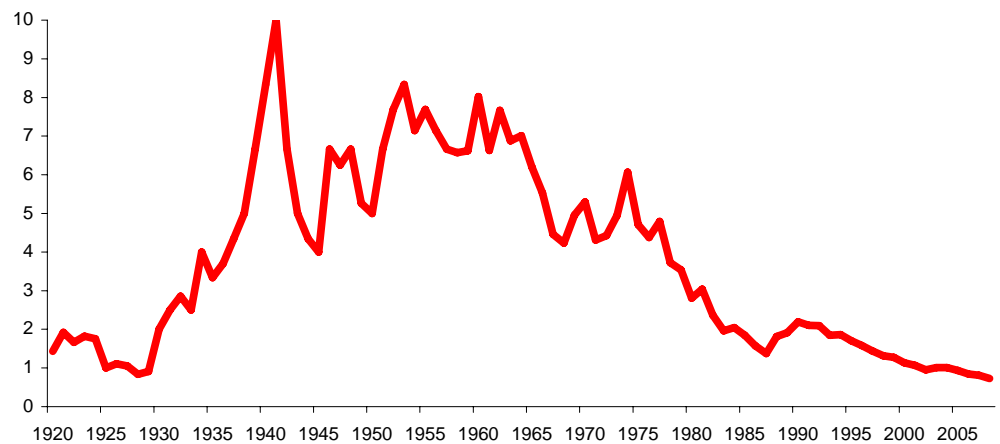


Source SG Global Strategy Research

However, it appears as if patient long-term investors are a vanishing species. As Keynes noted “Compared with their predecessors, modern investors concentrate too much on annual, quarterly, or even monthly valuations of what they hold, and on capital appreciation.... And too little on immediate yield.... And intrinsic worth”.

As the chart below shows, the average investor appears to have a chronic case of attention deficit hyperactivity disorder. The average holding period for a stock on the NYSE is six months! Under this time horizon, the only thing that any one cares about is: what is going to happen next quarter?

Average holding period for a stock on the NYSE (years)



Source SG Global Strategy Research

As Keynes opined “The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only”.

Of course, the obsession with the short term creates an opportunity. If everyone else is dashing around pricing assets on the basis of the next three months, then they are likely to mis-price assets for the longer term. So an opportunity for time arbitrage arises for the investor with a longer horizon. Sadly, as Keynes observed, “Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable”.

This is not to say that the value approach leads one to be totally immune from the market. In the event of a value trap, patience can lead to disaster. To guard against this possibility, a lot of time should be spent on reviewing positions that move against you. If a position goes ‘bad’ then a review should be triggered. The aim of the review should be to start from a blank sheet of paper and consider what should be done now.

If nothing fundamental has changed (i.e. this is just a case of price volatility being an order of magnitude higher than fundamental volatility) then the opportunity arises for an increase in the position (assuming limits haven’t been hit). If something fundamental and material has altered then the position can be cut.

Accepting the integral role of patience also means that leverage will be avoided. Leverage limits the staying power of an investor and thus must be shunned. As Keynes observed “An investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money”.

Patience is also required because the curse of the value manager is to be too early – both in terms of the buy (known affectionately as premature accumulation) and sell decisions. Unfortunately, in the short term being early is indistinguishable from being wrong.

We followers of value tend to get out of positions when they start to look expensive, rather than when they look ridiculously overvalued. My own work is a litany of premature problem spotting. For instance, calling Thailand the next Mexico in 1995, arguing that the equity market

was enjoying one last hurrah in 1997 (before losing my head in the mania of the tech bubble), pointing out the bubble characteristics of both the US housing market and commodities in 2005, and calling the mining sector a bubble in 2006.

If I was clairvoyant, I would be fully invested until the day before the crash and never buy until the bottom. However, since I don't possess a crystal ball (and I haven't met anyone else who does either), I can see no alternative but to continue to act in a patient, cautious fashion. This means positions need to be built slowly over time.

Patience is also required when the bottom-up search for value fails to uncover anything of merit. In the past I have suggested that most investors suffer an action bias (see [Mind Matters 7 January 2008](#)) – effectively a propensity to 'do' something. I have long found succour in the words of Winnie-the-Pooh "Never underestimate the value of doing nothing". If I can't find something to invest in then I am best off doing nothing at all.

Warren Buffett often talks of the importance of waiting for the 'fat pitch'. "I call investing the greatest business in the world," he says, "because you never have to swing. You stand at the plate, the pitcher throws you General Motors at 47! U.S. Steel at 39! and nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it."

However, most institutional investors behave "like Babe Ruth at bat with 50,000 fans and the club owner yelling, 'Swing, you bum!' and some guy is trying to pitch him an intentional walk. They know if they don't take a swing at the next pitch, the guy will say, 'Turn in your uniform.'"

Buffett often refers to *The Science of Hitting*, a book written by Red Sox legend Ted Williams. In it, Williams describes part of the secret to his phenomenal .344 career batting average. The theory behind Williams' extraordinary success was really quite simple (as many of the best ideas generally are).

He split the strike zone into 77 cells, each of which made up the size of a baseball, and rather than swing at anything that made its way into the strike zone, he would swing only at balls within his best cells, the sweet spot -- the ones he knew he could hit. If balls didn't enter his best cell, he simply waited for the next one -- even if it meant striking out now and then.

Thus, just as Williams wouldn't swing at everything, investors should wait for the fat pitch. Thus when the bottom-up search for opportunities fails, investors would be well advised to hold cash. As the Sage of Omaha has said "Holding cash is uncomfortable, but not as uncomfortable as doing something stupid."

Tenet IV - Be unconstrained

One of the evils of modern day finance is an obsession with pigeon-holing managers. This has always struck me as slightly daft. If I have a good manager why wouldn't I want him to invest where he thought the opportunity lay?

For instance, in my work over the last five months or so I have been trying to construct a portfolio of assets based around three themes: cash as a hedge against deflation (and to act as a feeder to deploy capital into my other two categories), deep value opportunities in both fixed income and equity space and, finally, sources of cheap insurance such as TIPS, gold and dividend swaps.

Of course today, most managers are forced to be specialist, leaving the ‘asset allocation’ decisions to the end client (a group who generally have an even more tenuous grasp on how to invest than the average fund managers). These constraints prevent investors from exploiting the full range of the opportunity set they are confronted by. A portfolio such as the one I have outlined would be unthinkable to many investors, or would require a large number of specialist managers.

Similarly, there may be times, like last year, when my analysis tells me the best place to be is net short (see [Mind Matters, 13 May 2008](#)). Early last year, my screens were throwing up the highest number of short ideas I have ever seen. Simultaneously, the long side was pretty much bereft of potential opportunities. This was a clear signal that the advantage was on the short side. Yet many managers found themselves constrained to be fully invested!

Artificially constraining a manager seems to be to like hiring Robert Plant but telling him he can only sing lullabies. As long as I find investments within my ‘circle of competence’, to borrow Buffett’s phraseology, why shouldn’t I be free to exploit them?

Tenet V - Don't forecast

I have tried to make this a list of 'dos' rather than a list of 'don'ts' but I have to include one giant DON'T. The folly of forecasting is one of my pet hobby-horses. I simply can't understand why so many investors spend so much time engaged in an activity which has so little value, and so little chance of success.

For instance, let's say you invest according to the following process: forecast the economy, forecast the path of interest rates, forecast the sectors which will do well within that environment, and finally forecast which stocks will do well within that sector.

Now let's assume you are pretty good at this and you are right on each forecast 70% of the time (massively above the rates actually seen). However, if you require all four forecasts to be correct, then you have just a 24% chance of actually getting it right! (This assumes that each of the forecasts is an independent event). Now think about the number of forecasts an average analyst model contains. Sales, costs, taxes, etc – no wonder these guys are never right.

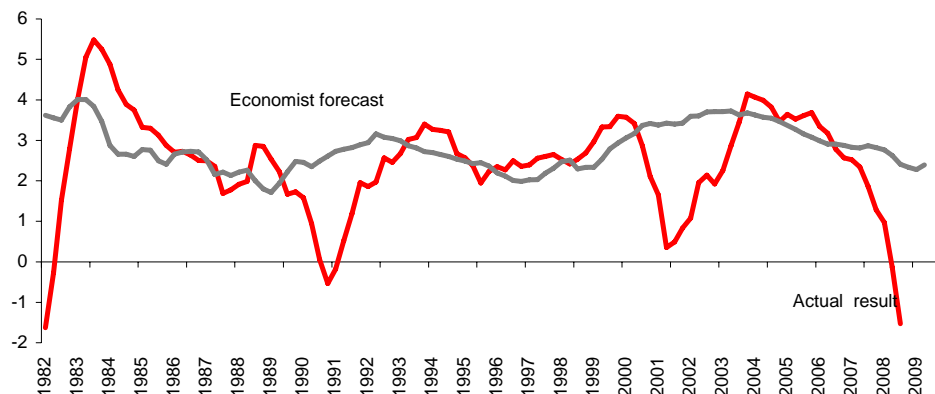
In addition, even if by some miracle of divine intervention your forecast turns out to be correct, you can only make money from it, if (and only if) it is different from the consensus. This adds a whole new dimension of complexity to the problem.

Organisations like Starmine take great pride in revealing who the most accurate analyst is each year. However, if you cast your eye down the list of winners, sadly there is very little persistence. Effectively this suggests that a 'lucky fool' won the competition with an outlier forecast. It should also be noted that each year someone has to be the most accurate analyst! It doesn't mean they were actually right, potentially they were just less wrong than their brethren.

The evidence on the folly of forecasting is overwhelming and would fill many notes in its own right. However, let's just skate through a few charts which show just how appalling forecasting really is.

Let's start at the top, the economists. These guys haven't got a clue. Frankly the three blind mice have more credibility than any macro-forecaster at seeing what is coming. The chart below shows they constantly fail to predict recessions (until we are firmly in one), and even then they do so only under duress.

US GDP and economists' forecasts (4q ma, %)

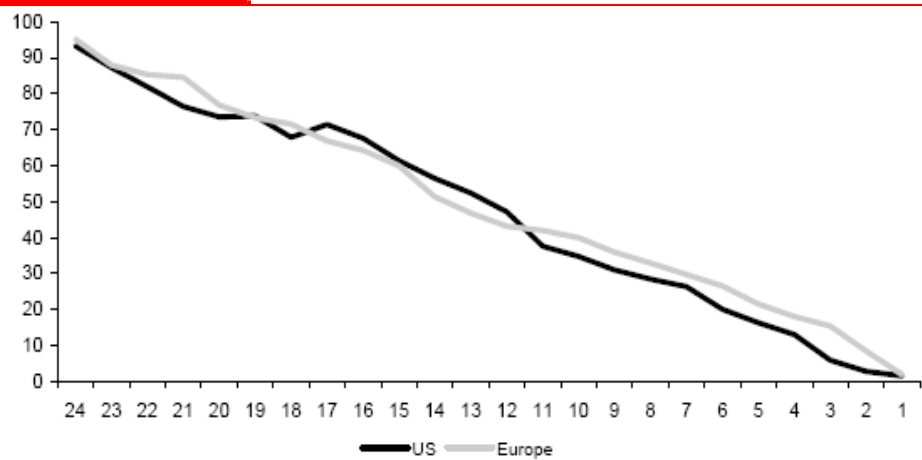


Source SG Global Strategy Research

The analysts are no better. Their forecasting record is simply dreadful on both short- and long-term issues. My colleague Rui Antunes has examined the accuracy of analysts. Rather than doing the analysis at the aggregate level (as I have done in the past) Rui, ever the pedant, has investigated the scale of the error at the individual stock level.

The chart below shows the average scale of the analysts' forecast errors over time. In the US, the average 24-month forecast error is 93%, and the average 12-month forecast error is 47% over the period 2001-2006. The data for Europe are no less disconcerting. The average 24-month forecast error is 95%, and the average 12-month forecast error is 43%. To put it mildly, analysts don't have a clue about future earnings.

Forecast error over time: US and European markets 2001-2006, %

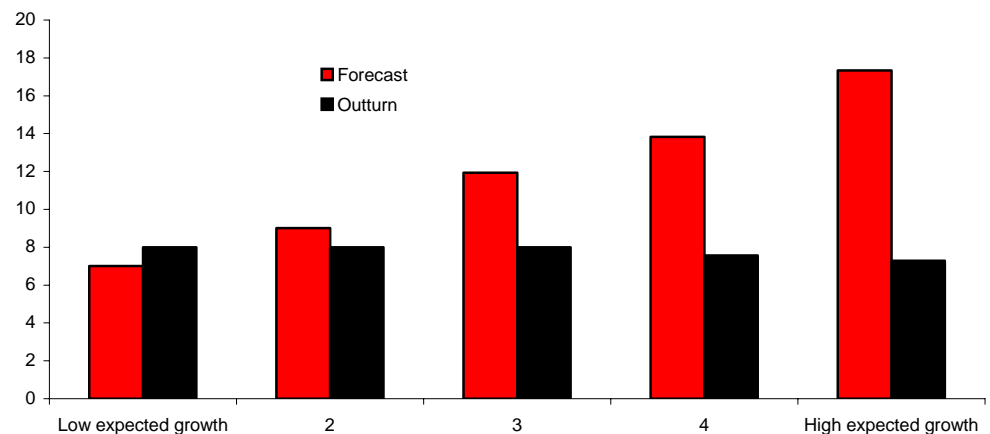


Source: SG Global Strategy

Analysts' performance in divining the longer-term future is sadly no better than their performance in the short term. The chart below shows the five-year forward growth rates from analysts, and the actual outturns. Quintile 5 are all the stocks the analysts expect to grow fast, and quintile 1 are the stocks the analysts expect to grow slowly.

Even a cursory glance at the chart reveals that the outcomes show no statistical difference across quintiles. That is to say, analysts have absolutely no idea about forecasting long-term growth.

Long-term growth forecasts and outcomes (US, 1982-2008, %)



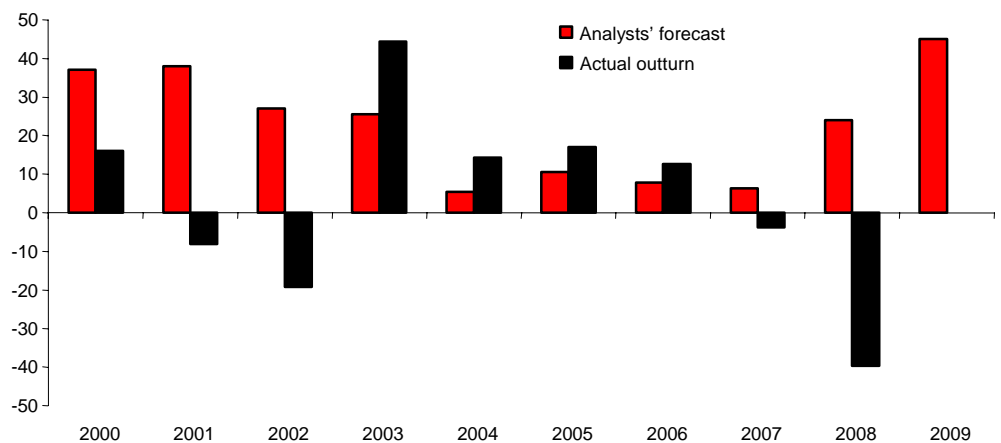
Source: SG Global Strategy

My final rant on the folly of forecasting concerns target prices. Why do analysts persist in trying to forecast prices? As Ben Graham said “Forecasting security prices is not properly a part of security analysis.”

The chart below shows the embarrassing track record that analysts have managed to rack up with respect to target prices. For each year, I have taken the price of the security at the start of the year, and assumed that the analyst’s target price is a view of where the price should be in 12 months’ time. On average the analysts expect stocks to be 25% higher each year!

I have then contrasted this implied analyst view with the actual returns achieved across the same universe. As you can see, the results are not favourable to the worth of target prices. In four out of the nine years, analysts have not even managed to get the direction of change in prices correct! The absolute scale of the average forecast error is 25%.

Analyst expected returns (via target prices) and actual returns (US, %)



Source: SG Global Strategy

The bottom line from this whistle stop tour of the failure of forecasting is that it would be sheer madness to base an investment process around our seriously flawed ability to divine the future. We would all be better off if we took Keynes’ suggested response when asked about the future, “We simply do not know”.

Tenet VI - Cycles matter

The sixth tenet that I would like to suggest is that cycles matter – even for long-term investors. As Howard Marks of Oaktree Capital puts it, while we may not be able to predict, we can prepare. All sorts of cycles exist, economic, credit, and sentiment, to name but three.

It is often said that markets are driven by fear and greed. However, they generally only appear one at a time. The market’s mood swings from irrational exuberance, to the depths of despair, Mr Market really is a manic depressive.

As Howard Marks wrote recently:

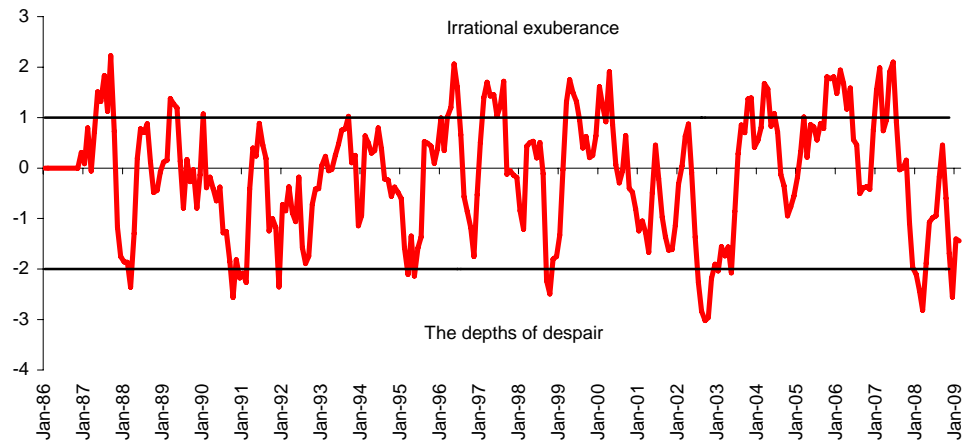
In my opinion, there are two key concepts that investors must master: value and cycles. For each asset you're considering, you must have a strongly held view of its intrinsic value. When its price is below that value, it's generally a buy. When its price is higher, it's a sell. In a nutshell, that's value investing.

But values aren't fixed; they move in response to changes in the economic environment. Thus, cyclical considerations influence an asset's current value. Value depends on earnings, for example, and earnings are shaped by the economic cycle and the price being charged for liquidity.

Further, security prices are greatly affected by investor behavior; thus we can be aided in investing safely by understanding where we stand in terms of the market cycle. What's going on in terms of investor psychology, and how does it tell us to act in the short run? We want to buy when prices seem attractive. But if investors are giddy and optimism is rampant, we have to consider whether a better buying opportunity mightn't come along later.

One of our proxies for where we stand is shown in the chart below. It attempts in a simplistic fashion to measure where we stand in the oscillations between the zenith of euphoria and the nadir of despair. I certainly can't predict where it is going, but I can prepare for the swings, and try to take advantage of the opportunity set that is created by these swings. It gives rise to a sliding scale of capital commitment driven by a desire to lean against the wind.

Our fear and greed index



Source: SG Global Strategy

In part this is obviously strongly related to tenet II on being contrarian. As Sir John Templeton said "To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest rewards".

As Seth Klarman notes in Margin of Safety "There are many explanations for volatility in business value. The 'credit cycle', the periodic tightening and relaxation of the availability of credit, is a major factor, for example, because it influences the cost and terms upon which money can be borrowed. This in turn affects the multiples that buyers are willing to pay for businesses. Simply put, buyers will willingly pay higher multiples if they receive low-rate non-recourse financing than they will in an unleveraged transaction."

Remembering that cycles occur is of vital importance, for it helps to remind one to sell as things become dear, and buy as they become cheap. But it also reinforces the need for slow position building, as we never know if we are at a top or a bottom of a cycle until after it has passed.

Tenet VII – History matters

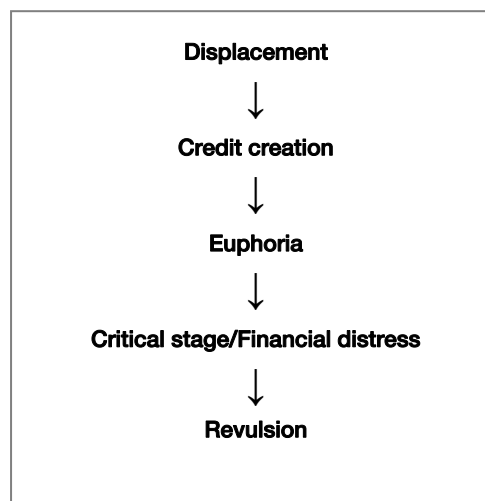
Sir John Templeton also observed that “This time is different” were the four most dangerous words in investing. Or as JK Galbraith said, the markets are characterised by “Extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavour in which history counts for so little as in the world of finance”.

Perhaps my favourite quotation on the lack of historical appreciation in finance comes from Jeremy Grantham who, when asked “Do you think we will learn anything from this turmoil?” responded “We will learn an enormous amount in the very short term, quite a bit in the medium term and absolutely nothing in the long term. That would be the historical precedent.”

Our industry often appears to be devoid of any appreciation of what has happened in the past. I often think that we would all be well served if, instead of studying the esoteric and complex maths of Black and Scholes and Ito’s Lemma, those working in finance were required to study the history of what has gone before.

Strangely enough, the CFA ensures that its charter holders are conversant in the mechanics of DCF, and can recite the joys of VaR, but notably absent is a chapter (let alone a module) on the lessons offered by financial history. As Ben Graham argued “Prudence suggests that he [the investor] have an adequate idea of stock market history, in terms particularly of the major fluctuations... With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers... of the market”.

Nowhere is an appreciation of history more important than in understanding bubbles. As I have written before, we have long been proponents of the Kindleberger/Minsky framework for analysing bubbles (see Chapters 38 and 39 of Behavioural Investing for all the details). Essentially this model breaks a bubble’s rise and fall into five phases as shown below.



Displacement – The birth of a boom

Displacement is generally an exogenous shock that triggers the creation of profit opportunities in some sectors, while closing down profit availability in other sectors. As long as the opportunities created are greater than those that get shut down, investment and production will pick up to exploit these new opportunities. Investment in both financial and physical assets is likely to occur. Effectively we are witnessing the birth of a boom.

Credit creation – The nurturing of a bubble

Just as fire can't grow without oxygen, so a boom needs liquidity to feed on. Minsky argued that monetary expansion and credit creation are largely endogenous to the system. That is to say, not only can money be created by existing banks but also by the formation of new banks, the development of new credit instruments and the expansion of personal credit outside the banking system.

Euphoria

Everyone starts to buy into the new era. Prices are seen as only capable of ever going up. Traditional valuation standards are abandoned, and new measures are introduced to justify the current price. A wave of overoptimism and overconfidence is unleashed, leading people to overestimate the gains, underestimate the risks and generally think they can control the situation.

Critical stage/Financial distress

The critical stage is often characterised by insiders cashing out, and is rapidly followed by financial distress, in which the excess leverage that has been built up during the boom becomes a major problem. Fraud also often emerges during this stage of the bubble's life.

Revulsion

This is the final stage of a bubble's life cycle. Investors are so scarred by the events in which they participated that they can no longer bring themselves to participate in the market at all. This results in bargain basement asset prices.

As the table on page 16 shows, the key features of bubbles are unnervingly similar. While the specific details of each bubble are unique, the overall patterns are essentially the same. Surely learning to spot these signs would be a worthwhile pursuit.

Strategy Research

The pattern of historical bubbles

Event	South Sea Bubble (1710-20)	First British railway boom (1845)	US 1873 railway boom	1920s US equity bubble	1960s conglomerate mergers boom	1980s Japanese land and equity bubbles	TMT bubble	Credit/Risk bubble
Displacement	Profits from conversion of government debt, supposed monopoly on trade with Spanish Americas	End of depression, new means of transport	End of the Civil War, settlement of the west	Decade of fast growth, end of WWI, rapid expansion of mass production	Two decades of rising stock markets, the joy of growth investing	Financial liberalisation, monetary easing	Widespread acceptance of the internet, strong growth and monetary easing	Low rates, rising house prices, Great Moderation
Smart money response	Insiders buy up debt in advance of the conversion	Build a railroad	Construction of government subsidised railroads	Expansion of supply of new shares, creation of new closed end funds	Emergence of professional conglomerates	Zaitech	Aggressive growth funds, stock options and IPO boom	Any and all kinds of leverage
Sustaining the bubble	Development of the coffee house network for speculation	?	Additional railroad charters	Regional exchanges, growth of margin accounts and broker loans	Stock swaps to create apparent earnings growth	Cross share holders, latent asset value, PKO in '87	Pro forma earnings, new valuation measures, buybacks	New derivative structures – CDOs, CDOs squared, new mortgage products, buybacks
Authoritative blessing	Government approval, royal involvement	Government approval of each railroad	Henry Varnum Poor and Charles Frances Adams	Blessing from Coolidge, Hoover, Mellon and Irving Fisher	McGeorge Bundy	Nomura calls for 80,000 by 1995	Greenspan	Greenspan, Bernanke, Bush
Swindle/Fraud	Ponzi Scheme	George Hudson paying dividends out of capital (Ponzi scheme)	?	Russell Snyder and Samuel Insull buying binge and debt mountain	National Student Marketing Corp.	Recruit Cosmo, Bubble lady	Enron, WorldCom, Tyco etc	Mark to model/myth, Madoff, Stanford
Political reaction	Ex post facto punishing of the directors, restrictions on the use of corporate form	Reform of accounting standards, rules passed so that dividends must be paid out of earnings not capital	?	Glass-Steagall Act, creation of the SEC, the holding company act.	Reform of accounting practice and the Williams Act	?	Sarbanes Oxley	??

Source: SG Global Strategy Research

Tenet VIII – Be sceptical

In trying to write down the list of tenets that form the approach I follow, it was sometimes hard to work out where one tenet began and another ended. Being sceptical was one of those that seemed to be covered by other tenets, but I felt it was worthy of examination in its own right. One of my non-finance heroes (Bruce Springsteen) once remarked that “Blind faith in anything will get you killed”. I share this view on the dangers of lack of critical thinking.

Over the years, I have had the privilege of knowing some of the best investors (judged by both their decisions and their results). One of the hallmarks they share is a healthy degree of scepticism.

Indeed, I would go as far as to say that they have a very different default when it comes to investing relative to the vast majority of fund managers. Their default option is non-ownership. They need to be convinced of the merits of an investment. This provides an inbuilt scepticism to their approach. They aren't willing to simply take things at face value. Their desire to understand the potential downside risks ensures they focus on what could go wrong, rather than dreaming of what could go right.

Most fund managers (especially those engaged in the relative performance derby) are more concerned with tracking error than scepticism. Their default is: Why shouldn't I own this investment? This short-circuits the sceptical inquiries that mark out those top investors.

Scepticism is also vital for those of us whose work regularly takes them in the dark side (aka the short side). As mentioned in tenet IV, I have no problem with being net short if that is where the opportunities lie. Indeed, I think short selling should be encouraged, not outlawed. As I have written many times before, the short sellers I know are among the most fundamentally orientated investors I have ever met. They take their analysis very seriously (as they should, since their downside is effectively unlimited). There can be no substitute for independent thinking, solid research and a healthy degree of scepticism.

Tenet IX – Be top-down and bottom-up

I started my career in finance as an economist (not something I admit in public very often; in fact I started out as an econometrician, which is possibly even worse). However, one of the few things I learned from my years in the wilderness was that top-down and bottom-up are largely inseparable (much like value and growth – they aren't mutually exclusive; as Buffett said, they are joined at the hip).

In his book on value investing, Marty Whitman says “Graham and Dodd view macrofactors... as crucial to the analysis of a corporate security. Value investors, however, believe that macrofactors are irrelevant”. If this is the case then I am very proud to say I am a Graham and Dodd fundamentalist.

While stock selection is best approached from the bottom-up, ignoring the top-down can be extraordinarily expensive. The last year has been a perfect example of why understanding the top-down can benefit and inform the bottom-up. The last 12 months have been unusual for value investors as two clear camps emerged from their normally more homogenous whole (as I have written before).

A schism over financials has split value investors into two diametrically opposed groups. The optimistic/bottom-up view was typified by Richard Pzena. In his Q1 2008 quarterly report he wrote:

A new fear has permeated conventional investment thinking: the massive leveraging-up of the recent past has gone too far and its unwinding will permanently hobble the global financial system. This view sees Bear Stearns as just one casualty in a gathering wave that has already claimed many U.S. subprime mortgage originators along with several non-U.S. financial institutions and will cause countless others to fail. And it sees the earnings power of those that survive as being permanently impaired.

The obvious question then is, which scenario is more logical: the extreme outlook described above, given the long period of easy credit extended to unqualified individuals? Or the scenario of a typical credit cycle that will work its way out as other post-excess crises have, and without impairing the long-term ROEs of the survivors? We believe the latter.

The alternative view (pessimistic, top-down informed) is well summed up by Steven Romick of First Pacific Advisors in a recent interview in Value Investor Insight:

VII: Has your negative general view on the prospects for financial services stocks changed at all?

SR: We believe in reversion to the mean, so it can make a lot of sense to invest in a distressed sector when you find good businesses whose public shares trade inexpensively relative to their earnings in a more normal environment. But that strategy lately has helped lead many excellent investors to put capital to work too early in financials. Our basic feeling is that margins and returns on capital generated by financial institutions in the decade through 2006 were unrealistically high. "Normal" profitability and valuation multiples are not going to be what they were during that time, given more regulatory oversight, less leverage (and thus capital to lend), higher funding costs, stricter underwriting standards, less demand and less esoteric and excessively profitable products.

Essentially, the difference between these two camps comes down to an appreciation of the importance of the bursting of the credit bubble. Those who understood the impact of the bursting of such a bubble didn't go near financials (and are generally still not prepared to engage in knife-catching in this sector). Those who focused more (and in some cases exclusively) on the bottom-up just saw cheapness.

It often pays to remember the wise words of Jean-Marie Eveillard, "Sometimes, what matters is not so much how low the odds are that circumstances would turn quite negative, what matters more is what the consequences would be if that happens".

As mentioned above, while we can't predict we can prepare. The credit bubble wasn't a black swan (see Mind Matters, [13 March 2008](#)), although we might not have been able to forecast when its demise would occur, we could at least prepare for its passing on by avoiding credit bubble-related stocks such as financials and housebuilders, for instance.

The bottom-up can also inform the top-down. As Ben Graham pointed out "True bargain issues have repeatedly become scarce in bull markets... Perhaps one could even have determined whether the market level was getting too high or too low by counting the number

of issues selling below working capital value. When such opportunities have virtually disappeared, past experience indicates that investors should have taken themselves out of the stock market and plunged up to their necks in US Treasury bills.”

Another example of the complementary nature of top-down and bottom-up viewpoints is offered by Seth Klarman. In his insightful book, *Margin of Safety*, Klarman points out that the inflationary environment can have dramatic consequences for value investors:

Trends in inflation or deflation also cause business values to fluctuate. That said, value investing can work very well in an inflationary environment. If for fifty cents you buy a dollar of value in the form of an asset, such as natural resource properties or real estate, which increases in value with inflation, a fifty-cent investment today can result in the realisation of value appreciably greater than one dollar. In an inflationary environment, however, investors may become somewhat careless. As long as assets are rising in value, it would appear attractive to relax one's standards and purchase \$1 of assets, not for 50 cents, but for 70 or 80 cents (or perhaps even \$1.10). Such laxity could prove costly, however, in the event that inflation comes to be anticipated by most investors, who respond by bidding up security prices. A subsequent slowdown in the rate of inflation could cause a price decline.

In a deflationary environment assets tend to decline in value. Buying a dollar's worth of assets for fifty cents may not be a bargain if the asset value is dropping. Historically investors have found attractive opportunities in companies with substantial "hidden assets," such as an overfunded pension fund, real estate carried on the balance sheet below market value, or a profitable finance subsidiary that could be sold at a significant gain. Amidst a broad-based decline in business and asset values, however, some hidden assets become less valuable and in some cases may become hidden liabilities. A decline in the stock market will reduce the value of pension fund assets; previously overfunded plans may become underfunded. Real estate carried on companies' balance sheets at historical cost may no longer be undervalued. Overlooked subsidiaries that were once hidden jewels may lose their lustre.

The possibility of sustained decreases in business value is a dagger at the heart of value investing (and is not a barrel of laughs for other investment approaches either). Value investors place great faith in the principle of assessing value and then buying at a discount. If value is subject to considerable erosion, then how large a discount is sufficient?

Should investors worry about the possibility that business value may decline? Absolutely. Should they do anything about it? There are three responses that might be effective. First, since investors cannot predict when values will rise or fall, valuation should always be performed conservatively, giving considerable weight to worst-case liquidation value as well as to other methods. Second, investors fearing deflation could demand a greater than usual discount between price and underlying value in order to make new investments or to hold current positions. This means that normally selective investors would probably let even more pitches than usual go by.

Finally, the prospect of asset deflation places a heightened importance on the timeframe of investments and on the presence of a catalyst for the realisation of underlying value. In a deflationary environment, if you cannot tell whether or when you will realise underlying value, you may not want to get involved at all. If

underlying value is realised in the near-term directly for the benefit of shareholders, however, the longer-term forces that could cause value to diminish become moot.

Thus neither top-down nor bottom-up has a monopoly on insight. Both perspectives have something to offer the open-minded investor.

Tenet X – Treat your clients like you would yourself

The final tenet of my creed takes us almost a full circle back to the aim of investing (which for those with both pachyderm-like memories and the extraordinary stamina required to make it thus far through this note, will recall was where we started).

One of the most useful questions I think a fund manager can ask is: Would I do this with my own money? All too often those charged with the stewardship of other people's money seem to think that this gives them licence to behave in an odd fashion (true of both fund managers and the corporate executives charged with running companies).

John Bogle put it well when he said our industry has ceased to be a profession and has become a business. This is a lamentable state of affairs. When marketing men run investment firms the result will be the wrong fund at just the wrong time. Witness the surge in tech funds in the late 1990s, or the rise of commodity funds in more recent years. I have long argued that we need a version of the hypocratic oath in finance with an overt promise to “first, do no harm”.

Paul Wilmott and Emanuel Derman recently proposed the following as the “Modelers’ Hippocratic Oath”

I will remember that I didn't make the world, and it doesn't satisfy my equations.

Though I will use models boldly to estimate value, I will not be overly impressed by mathematics.

I will never sacrifice reality for elegance without explaining why I have done so.

Nor will I give the people who use my model false comfort about its accuracy. Instead, I will make explicit its assumptions and oversights.

I understand that my work may have enormous effects on society and the economy, many of them beyond my comprehension.

Instead of trying to maximise assets under management, many of the best investors have chosen to deliberately limit the size of their funds, so as not to reduce their ability to deliver returns. Of course, this is anathema to the fund supermarkets, but it strikes me as the only way to sensibly approach investing. As Jean-Marie Eveillard said “I would rather lose half my clients than lose half my client's money”.

Incentives can be aligned without too much difficulty. For instance, buy-side analysts should be paid on a (say) three-year view of overall performance of the fund at which they work. This prevents them gaming the system and insisting on having positions in the portfolio. I would also suggest that analysts should be generalists rather than specialists. This allows them flexibility to assess different opportunities in different areas, but ensures a consistent framework is applied. However, here I am straying towards process rather than philosophy, which is the subject of this thesis.

Similarly, I am always happiest investing when I know the manager has a sizable stake in the fund alongside my own, simply because this helps ensure he asks himself the question with which I started this section on a regular basis.

Managers who follow the kind of creed I have outlined above will also need to select their clients with care. Having clients who truly understand the way you invest is vital, after all there is little point in trying to follow a patient strategy if your capital is pulled at just the wrong moment. Using pre-commitment devices such as lock-ins makes sense in this context – see Mind Matters, [22 September 2008](#).

Conclusion

This is perhaps one of the most personal notes I have written. It exposes my beliefs about the way in which investment should be approached. I have tried to avoid a discussion of process – not because I believe it to be unimportant (in fact nothing could be further from the truth, see Mind Matters, [1 September 2008](#)), but rather because I wanted to explore the philosophical beliefs that lie at the very core of the approach I follow.

Exposing one's beliefs can be a risky move, but just as sunlight is the best disinfectant, so I think exposing beliefs to critique is a useful exercise. Open and honest debate can often produce superior results. It is in this spirit I have tried to explain the way I approach investing. It certainly isn't the only way we could approach the problem, but it is the way that makes the most sense to me.

The 10 tenets of investing

Tenet I - Value, value, value

Tenet II- Be contrarian

Tenet III - Be patient

Tenet IV - Be unconstrained

Tenet V - Don't forecast

Tenet VI - Cycles matter

Tenet VII – History matters

Tenet VIII – Be sceptical

Tenet IX – Be top-down and bottom-up

Tenet X – Treat your clients as you would treat yourself

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