CHAPTER 14

A ROAD MAP TO CHOOSING AN INVESTMENT PHILOSOPHY

If the purpose of this book is to provide you with the tools to pick an investment philosophy, you may very well feel that it has failed. After all, there seems to be both good and bad in every philosophy and no one philosophy seems to dominate over time and yield consistent winners. What purpose has been served you may wonder from this examination of diverse and contradictory views of how markets work and fail to work? In this chapter, we hope to not only wrap up loose ends but also to bring the process of picking a philosophy back to you as an investor.

A Self Assessment

As we noted in chapter 1, there is no one investment philosophy that is best suited for all investors, and much of what we have said in the intervening chapters reinforces this point. A strategy that works for an investor who is patient and has substantial capital to invest may not work for an investor with unpredictable cash needs and a smaller portfolio. In this section, we will consider three aspects that will help determine your investment philosophy – your personal characteristics as an individual, your financial standing and the beliefs you have formed about markets.

Personal Characteristics

Investors who pick investment philosophies that do not fit their personalities are destined to abandon them sooner rather than latter, weighed down not just by the fact that they do not work for them but by personal discomfort with the vagaries of their portfolios. While some of the factors in this section may come perilously close to being on a psychiatrist's couch, you cannot be a successful investor if you do not have a clear eyed view of your own strengths and weaknesses.

a. Patience: Some investment strategies require a great deal of patience, a virtue that many of us lack. Much as you may plead with the powers that be for more patience, you have to accept the reality that you may not suited to an investment strategy that requires ten years of waiting for rewards. If impatient by nature, you should consider adopting an investment philosophy that provides payoffs in the short term.

b. Risk Aversion: Your willingness to bear risk should play a key role in what investment philosophy or strategy you choose for yourself. If you are risk averse, adopting a strategy that entails a great deal of risk – trading on earnings

announcements, for instance – will not be a strategy that works for you in the long term.

c. Individual or Group Thinker: Some investment strategies require you to go along with the crowd and some against it. Which one will be better suited for you may well depend upon whether you are more comfortable going along with the conventional wisdom or whether you are a loner. If you are easily subject to peer pressure, odds are high that you will be uncomfortable with contrarian philosophies. If on the other hand, you are comfortable going against the crowd, the fact that most investors are betting against you may bother you little or not at all.

d. Time you are willing to spend on investing: Some investment strategies are much more time and resource intensive than others. Generally, short-term strategies that are based upon pricing patterns or on trading on information are more time and information intensive than long-term buy and hold strategies.

e. Age: If you are an individual investor, your age clearly will make a difference in your choice of investment philosophy. To begin with, as you age, you may find that your willingness to take risk, especially with your retirement savings, decreases. Investment philosophies that you found attractive when you were younger may no longer be attractive or appropriate vehicles for you. With age, they say, also comes wisdom, though we are not sure that this adage applies to investing. It is true, though, that even as a successful investor, you will have learnt lessons from prior investment experiences that will both constrain and guide your choice of investment philosophy.

In summary, your choice of investment philosophy is only partially under your control. Even if you are a patient investor who is willing to go against the crowd, you may find that as you age and become more risk averse, your philosophy and the strategies that go with it have to be modified.

Signs of a misfit

1. You lie awake at night thinking about your portfolio. Investors who choose investment strategies that expose them to more risk than they are comfortable taking will find themselves facing this plight. It is true that your expected returns will be lower with low risk strategies, but the cost of taking on too much risk is even greater.
2. Day to day movements in your portfolio lead to reassessments of your future: While long term movements of your portfolio should affect your plans on when you will retire and what you will do with your future, day-to-day movements should not. It is common

in every market downturn to read about older investors, on the verge or retirement, having to put off retiring because of the damage created to their portfolios. While some of them may have no choice when it comes to where they invest, most investors do have the choice of shifting into low-risk investments (bonds) as they approach retirement.

3. Second guessing your investment decisions: If you find yourself second guessing your investment choices every time you read a contrary opinion, you should reconsider your strategy.

Financial Characteristics

Your choice of investment philosophy will also be affected by your financial characteristics – your job security, the funds you have to invest, your cash needs and your tax status. Since these characteristics change over time, you may have to modify your investment choices to reflect these changes.

Job Security and Earning Capacity

One of the interesting characteristics that we see with financial markets is that investors become more risk averse as the economy weakens - you see this in the widening of default spreads on bonds and in the increase in equity risk premiums during recessions. While we can present a macro economic story for why this happens, we suspect that a great deal of what we see reflects personal insecurity. In the midst of a recession, even those with jobs worry more about their investments and demand larger risk premiums for investing in assets. The flight to quality and, at the limit, to riskless investments is exacerbated by natural and financial crises.

Your investment philosophy will also be heavily influenced by what you perceive your earning capacity to be. If you expect to earn a high income that more than covers your expenses, you have far more degrees of freedom when it comes to picking an investment philosophy. If, on the other hand, your income barely covers your expenses or worse still, falls short, your investment portfolio will have to be tailored to meet your cash needs.

How will this affect your choice of investment philosophy? If you are lucky enough to have a high and predictable income, you can adopt an investment strategy that yields little in the short term but has large payoffs in the long term. If the lessons about risk and return that we have drawn in investing apply to human capital, high-income jobs will probably come with less security, and you will have to invest accordingly. Ultimately, your willingness to bear risk and your time horizon will be heavily influenced by both the level and predictability of your earnings.

Investment Funds

Your choices in terms of investment philosophy expand as the funds at your disposal increase. It may be unfair, but if you have a few thousand dollars to invest, you have little choice but to invest in an index fund. If, on the other hand, you have several hundred thousand dollars to invest, most of the investment philosophies in this book become viable. When considering the investment funds at your disposal, you should look at not only your savings but also money that you have accumulated in pension funds, IRAs and insurance savings accounts. While you are sometimes restricted in your investment choices on some of these funds, you have more choice now than you used to and odds are that your choices will continue to increase over time.

Cash Needs

One of the perils we face both as individual investors and portfolio managers is unpredictable demands for cash withdrawals. For individual investors, this may occur as the result of a personal crisis – a sickness that is not covered by health insurance or the unanticipated loss of income. For professional money managers, it arises because clients can change their minds and demand their money back. If this occurs, you may have to liquidate your investments and lose any long-term return potential that you may have in them.

If your cash demands are unpredictable, what can you do? While you may not be able to forecast when cash withdrawals may need to occur, you can still consider the probabilities when you choose your investment philosophy. If you are a salesman and you make the bulk of your income as a commission, you should expect more volatility in your income and a greater likelihood that you will have cash withdrawals. If you are a portfolio manager of a small, technology fund, you should also assume that your investors are much more likely to shift their savings out of your fund, if you have a bad year. In either case, the expected need for cash shortens your time horizon and may ultimately require you to adopt an investment philosophy with a shorter payoff period.

Tax Status

Much as you wish otherwise, you have to pay taxes and it would be imprudent to pick an investment strategy without considering your tax status. Investors who face high taxes on income should choose investment strategies that reduce their tax liabilities or at least defers taxes into the future. What makes the interplay between investment philosophy and taxes complicated is the fact that different portions of the same individual's income can be subject to different tax treatment. Thus, an investor, when deciding what to buy with her pension fund, where income is tax exempt, may adopt a strategy that generates large

amounts of current income, but when investing her personal savings, has to be more careful about tax liabilities.

Market Beliefs

This is perhaps the most difficult component for investors to wrestle with for several reasons. The first is that so much of what we believe about markets comes from anecdotal evidence – from friends, relatives and experts in the field. It is to provide a counter balance that we have looked at the prevailing empirical evidence and disagreements among researchers on what works and does not in financial markets. Needless to say, our work is not done since new research continues to be done.

The second problem is that your views about market behavior and the performance of investment strategies will undoubtedly change over time, but all you can do is make your choices based upon what you know today. In fact, while staying consistent to an investment philosophy and core market beliefs may be central to success in investing, it would be foolhardy to stay consistent as the evidence accumulates against the philosophy.

Finding an Investment Philosophy

We have looked at a variety of investment philosophies in the course of this book and provided some evidence on when they work best and when they fail. We have also categorized these strategies based upon a number of different dimensions – time horizon, funds needed for success and beliefs about market behavior. We will begin with a summary of these findings and then look at the matching an investment philosophy to your financial and personal characteristics.

The Choices

Considering again all of the choices in terms of investment philosophy laid out in this book, we can categorize them based upon the three criteria noted above. While some of these categorizations are hazy – a strategy may be more medium term than long term or more opportunistic than contrarian –they are useful nevertheless.

Time Horizon

The time horizon required to succeed at an investment philosophy and the strategies that flow from it runs the gamut. At one extreme are the long-term strategies such as investing in loser stocks (which have gone down the most over the last six months or year). These require you to invest for five or more years and success is by no means guaranteed even then. At the other extreme are strategies where the time horizon is measured in hours or days, which is where we would categorize trading on earnings announcements and pure

arbitrage strategies. In the middle lie strategies that need several months to unfold – buying stocks on relative strength is one example – to a few years.

Capital Requirements

The funds that you need to invest to be successful at investing also vary across strategies. Some strategies require very large portfolios and the benefits that flow from them – low transactions costs, large positions in individual companies and diversification. This is true, for instance, with activist value investing and activist growth investing. Other strategies may be feasible even to investors with small portfolios – a style switching strategy where you switch from value to growth mutual funds and vice versa, depending upon your expectations of earnings growth in future periods would be a good example. Finally, there are some strategies where you need to be large enough to be able to have low execution costs and access to debt but not so large that you create a price impact every time you trade. This is the case with several near or pseudo arbitrage strategies.

Market Beliefs

We can categorize all of the investment strategies described in this book into three groups based upon the underlying market beliefs that drive them. The first set of strategies can be categorized as momentum strategies – i.e. they are based upon the assumption that what has happened in the recent past is likely to continue to happen in the future. Here, we would include most of the technical momentum indicators, such as trend lines and relative strength, as well as some passive growth investing strategies that are based upon momentum in earnings growth. The second set of strategies are contrarian strategies, where you assume that there is a tendency for all aspects of firm behavior – earnings growth, stock returns and multiples such as price earnings – to revert back to historical averages over time. Value investing strategies, where you buy stocks whose prices have hit lows or after substantial bad news, is a good example, as are market timing strategies based upon normalized PE and interest rates. The third set of strategies are opportunistic, where you assume that markets make mistakes but that these mistakes can sometimes lead prices to overshoot (which is what contrarians assume) and sometimes to undershoot (which is what momemtum investors assume). Most arbitrage strategies and some technical indicators (such as price patterns and cycles) can be categorized in this group. Note that there is a fourth group here that we have not recognized explicitly. If we assume that markets are efficient – mistakes are random, cut both ways and are unlikely to be uncovered by investors searching for them – the appropriate strategy is indexing.

In table 14.1, we have categorized most of the strategies described in this book, based upon time horizon and market beliefs. We have also highlighted the strategies that we believe are not feasible for small investors.

Table 14.1: Categorizing Investment Philosophies

	Momentum	*Contrarian*	*Opportunisitic*
Short term (days to a few weeks)	Technical momentum indicators – Buy stocks based upon trend lines and high trading volume. Information trading: Buying after positive news (earnings and dividend announcements, acquisition announcements)	Technical contrarian indicators – mutual fund holdings, short interest. These can be for individual stocks or for overall market.	*Pure arbitrage in derivatives and fixed income markets.* Tehnical demand indicators – Patterns in prices such as head and shoulders.
Medium term (few months to a couple of years)	Relative strength: Buy stocks that have gone up in the last few months. Information trading: Buy small cap stocks with substantial insider buying.	Market timing, based upon normal PE or normal range of interest rates. Information trading: Buying after bad news (buying a week after bad earnings reports and holding for a few months)	Near arbitrage opportunities: Buying discounted closed end funds *Speculative arbitrage opportunities: Buying paired stocks and merger arbitrage.*
Long Term (several years)	Passive growth investing: Buying stocks where growth trades at a reasonable price (PEG ratios).	Passive value investing: Buy stocks with low PE, PBV or PS ratios. Contrarian value investing: Buying losers or stocks with lots of bad news.	*Active growth investing: Take stakes in small, growth companies (private equity and venture capital investing)* *Activist value investing: Buy stocks in poorly managed companies and push for change.*

Italics: Strategies that are not feasible for small investors

The Right Investment Philosophy

Once you have an inventory of your personal needs and preferences, finding an investment philosophy that is most appropriate for you should be a simple exercise, but you have two choices:

Single Best Strategy: You can choose the one strategy that best suits you. Thus, if you are a long-term investor who believes that markets overreact, you may adopt a passive value investing strategy.

Combination of strategies: You can adopt a combination of strategies to maximize your returns. For instance, you may mix in a basic long-term strategy of passive growth investing with a medium term strategy of buying stocks with high relative strength. Obviously, you are hoping to augment your returns from the first strategy with your returns on the second. In creating this combined strategy, you should keep in mind the following caveats:

- You should not mix strategies that make contradictory assumptions about market behavior over the same periods. Thus, a strategy of buying on relative strength would not be compatible with a strategy of buying stocks after very negative earnings announcements. The first strategy is based upon the assumption that markets learn slowly whereas the latter is conditioned on market overreaction.
- When you mix strategies, you should separate the dominant strategy from the secondary strategies. Thus, if you have to make choices in terms of investments, you know which strategy will dominate.

Review

Investing is a continuous process and we learn (or should learn) all the time from both our successes and failures. We learn about how other investors in the market behave and we learn about ourselves. Our circumstances in terms of job security (or at least the perception of it) and income also change. As a consequence, we may have to revisit the decision of which investment philosophy is best suited repeatedly, and in some cases, change to reflect both what we have learnt in the recent past and our current status. In making these changes, though, we should fight the temptation to go with the strategy that worked best in the recent past or expert advice. Financial experts, for the most part, are no better at forecasting the future than the rest of us.

Conclusion

Choosing an investment philosophy is at the heart of successful investing. To make the choice, though, you need to look within before you look outside. The best strategy for you is one that matches both your personality and your needs. If you are patient by nature, have a secure income stream and little or no need for cash withdrawals, you can choose a strategy that may be risky in the short term but has a good chance of paying off in the long term. If, on the other hand, you cannot wait for extended periods and have immediate cash needs, you may have to settle for a shorter-term strategy.

Your choice of philosophy will also be affected by what you believe about markets and investors and how they work (or do not). You may come to the conclusion that markets overreact to news (in which case you would migrate towards contrarian strategies), markets learn slowly (leading to momentum strategies), markets make mistakes in both directions (yielding opportunistic strategies) or that market mistakes are random. Since your beliefs are likely to be affected by your experiences, they will evolve over time and your investment strategies have to follow suit.