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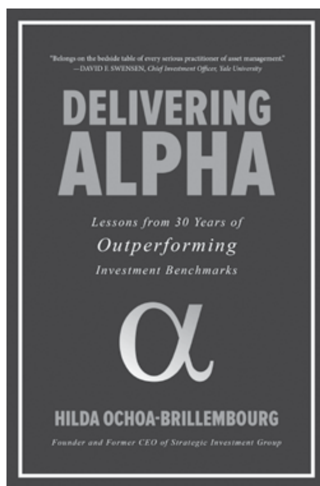
Outperforming *the* Market



An excerpt from **Delivering Alpha: Lessons from 30 Years of Outperforming Investment Benchmarks** *by Hilda Ochoa-Brillembourg (McGraw-Hill Education, 2018).*

An important investor offers four key lessons.

1. Price Is Not Value

The value of an asset to any particular investor may be lower or higher than the price (or fair value) of the asset in the marketplace, depending on the correlation of that asset to the investor's legacy (existing) portfolio and needs. This is true even if the investor agrees with market forecasts. Many portfolios contain legacy assets or structures (and reflect client needs) that cannot be easily or cost-effectively changed. Financial theory is insufficient to understand the relationship between market prices and investors' utility curves, which lead to different "fair values" (multiple equilibrium pricing) for the same asset depending on the investor. Assets have a *market price* available to all buyers but have a different relative *value* to different buyers. Part I of *Delivering Alpha* offers a shortcut formula I have found useful to begin identifying assets that fit your legacy portfolio better than other assets.

There is a brilliant moral assessment of flawed characters we encounter in life in Oscar Wilde's swipe at people who know "the price of everything and the value of nothing." In investing as in life, theory may teach you how the market sets the *price* of assets, but it will not fully tell you whether that price equals the *value* of that asset when added to *your* existing portfolio. In the world of efficient-market believers, this first lesson is probably the most controversial of my findings and possibly the most relevant. The difference between market value and value to an investor might help explain the gap between multiple equilibriums in efficient and inefficient markets—those conditions where different investors are willing to pay different prices for similar assets at the same time.

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The value of an investment to a particular buyer will be determined by the *market price,* the e*xpected return and risks,* and the *correlation of that marginal investment to your legacy portfolio.* Few institutional portfolios start with cash. And even if one does, once you have built an optimal portfolio structure from cash, you have a legacy portfolio to contend with. Every new asset added to the legacy portfolio may have a different value to your portfolio than it has to the market at large. The largest factor influencing such value, other than price, expected return, and risk, is the correlation of the asset to the rest of your portfolio. When a certain type of investor (e.g., a corporate buyer) is crowding into an asset to the point of overpricing it for other classes of investors (e.g., an endowment), the investor with no strategic interest in it should give it a pass. The asset fits one investor better than the other investor.

2. But Watch the Price

The price you pay for an asset is one of the most important determinants of the risk embedded in owning the asset. We don't ever know the perfect price for an asset, but we do know that an asset will likely be overpriced and more risky than average if its valuation is at a historic peak, or more than two standard deviations from historic fair value. Mean reversion for asset prices is a safe bet if you allow sufficient time for it to happen—except in times of war or extended market closures. Postmodern financial theory accepts that markets are not always fairly valued, as behavioral biases affect investors' rational choices and move markets away from fair value. Almost any management style works if the horizon is long enough, if you stick with the discipline, and if the timing of implementation isn't terrible. Put simply, almost any style works if you initiate it at a reasonable price and give it the requisite time to show its value.

Despite what Warren Buffett might say, many small and good bets are the most important source of superior returns and portfolio robustness.

There are some exceptions. Based on the valuable empirical finding that assets will tend to revert to a trending mean over time, we have found that pure *momentum* styles tend to create more extreme losses than gains over time. Momentum styles are those that invest more in securities whose prices are appreciating at a constant or increasing rate, hoping to detect when the trend is showing signs of reversing so as to pull out of the asset promptly. Momentum styles are generally used in fast-moving commodity-based investments, which don't lend themselves to fundamental price analysis (discounted cash flow) because they offer no cash flows to be discounted. One can employ a momentum technique if applied in combination with price-sensitive styles. In those cases, momentum is a valuable second filter.

If you pay a fair price, you will be fine over time. If you overpay, you may never fully recover your investment, and yet the best course of action may be to stay with the investment unless it is still grossly overvalued. Relative valuation should guide your decisions looking ahead. Much academic theory tries to prove that price-sensitive ("value") investing will pay off more frequently than momentum investing, because momentum investors will generally overpay for the assets they buy. But sometimes cheap assets remain cheap for a really long time (the so-called value trap). Identifying emerging momentum out of the value trap is important to avoid being caught for a long time in a cheap asset that isn't going anywhere.

According to Robert Shiller's analysis, cyclically adjusted P/E ratios (based on ten-year normalized real earnings) can help estimate the range of future long-term returns. Starting with a relatively low P/E of 8, the expected return would hover around 15 percent per year over the next ten to fifteen years, within a range of 8 to 18 percent. As adjusted P/E ratios rise from 8 to 20, expected returns drop to a range of 0 to 12 percent, with a mean value slightly above 5 percent. At starting P/E ratios of 30 to 40, it's difficult to clear positive returns for the next ten to fifteen years. Risks in asset classes other than equity are also dependent on the level of overvaluation or undervaluation at the time of purchase.

3. Don't Bet the House

We can't be certain of anything, regardless of how strong the evidence. Our experience has validated academic uncertainty theories regarding tail events (extreme, unexpected occurrences). Such events happen very infrequently but can be devastating if your portfolio isn't prepared to survive them. Still, portfolios should not be managed around tail events, because they are not the most likely outcome; portfolios should be managed so that risks taken are not devastating in an extreme scenario. We have to manage for the probable, but make sure unlikely events won't destroy our ability to reinvest in the probable. To this end, in *Delivering Alpha* I expand on the academic understanding of the limits and optimal manner of risk taking and liquidity management.

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Liquidity generally is either greatly overvalued or undervalued; valuing it properly is critical to handling uncertainty properly. Uncertainty is taken up in most sections of the book dealing with optimal policy, risk and liquidity management, and asset-class structuring.

4. Potholes Are Unavoidable

Intelligent diversification is the best way to control risk, even though the more you diversify, the more likely you are to step in a pothole. The mishap should have only a small impact on your portfolio but can embarrass and shame decision makers. Some perceptive recent academic theory on fragile and robust (resilient) structures, developed by observing biological evolution, deals properly with this issue. We need to be aware of the inherent but manageable weaknesses of robust structures. Attention to diversity and diversification of risks is central. Despite what Warren Buffett might say, many small and good bets are the most important source of superior returns and portfolio robustness for institutional portfolio managers. Multiple bets allow you to add new assets, new styles, and volatile but diversifying risks without subjecting the portfolios to outsize volatility and fragile (highly uncertain) outcomes. Buffett's unique skills over more than sixty years are supported by the preferred pricing that his well-established brand can command on purchases. From time to time there may be opportunities to place a larger bet in an asset that is undervalued (big game hunting), or away from an asset that is expensive, but those large bets—5 to 10 percent of total multi-asset-class assets in a single bet—should have uniquely high certainty, evidenced by a two-plus standard deviation from fair value. ◆