ARTICLE

Part 6 - Who Is On the Other Side of the Trade?

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When investors choose to invest in Smart Beta indices over Bulk Beta indices, they must believe that security prices are noisy and mean-reverting and/or that, in addition to market risk, there exist other sources of equity premia. While it is the case that we could each hold the market portfolio, it is not the case that every one of us could hold a value or a low beta portfolio. But in the aggregate we must own the market; and if someone holds a portfolio of value stocks, then someone else must hold a portfolio of expensive stocks. If someone is contrarian rebalancing into recent underperformers, someone must take the other side of the trade and chase into recent winners.

If regularly rebalancing into value and low beta stocks are such good investment propositions, who is investing in expensive stocks and high beta stocks? Who is on the other side of the trade? This is indeed the most important question to settle for investors in Smart Beta indices.

Let's focus first on value investing. At its core, value investing means selling what has become expensive and rebalancing into what has become cheap. Described in this language of cheap vs. expensive, value investing seems obviously right. However, very often the cheap stocks have become cheap and oversold because they have received a series of negative shocks. These negative shocks take the form of botched product launches, declining profit margins due to aggressive new competitors, spectacular mismanagement, and other highly visible corporate sins that result in firm distress. On the flip side, stocks that have rallied and become expensive have often had tremendous recent growth and widely celebrated successes—a golden boy CEO, a world-changing new product, a stunning acquisition.

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The first chapter in any investment textbook should warn against (1) confusing a good company for a good investment and (2) misconstruing one's personal opinion derived from perusing the financial press as valuable private information. However, anyone who has participated in performance reviews with investment committees would acknowledge that these two basic tenets are generally checked at the door.

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Because sentiment is contagious, because timing price corrections is hard, because we all want to brag about our four-bagger stock picks, because irrational markets can outlast our conviction and courage—we look the value gift horse in the mouth and protest, "But there is a risk that the fundamentals continue to deteriorate and this cheap firm gets cheaper." Or we say, "This company could be the next Google and Apple; at the current 600 PE, it is attractively priced. Let's hold it longer."

The dread of catching a falling knife and the desire to collect the greatest possible gain are not wrong qualitatively. It is absolutely true that many value stocks eventually go bust and that some growth stocks go on to become the next Google. The fear and greed are just off quantitatively. What the empirical finance literature finds over and over again is that the majority of value stocks overcome temporary setbacks and recover in price while most of the growth stocks never fulfill the market's hopes.

Indeed, many if not most of us are driven by fear and greed. It is human, and, on our evolutionary path, fear and greed probably served to keep us safe. So value investing is uncomfortable, not because you are likely to earn poor returns or experience significant risks relative to holding the market—it is uncomfortable because it goes against our genetic programming. From a cognitive and behavioral science perspective, the question to ask is, "Why would anyone pursue a contrarian value investing strategy?" As it turns out, very few people are able to be contrarian. But in the long run those who succeed in overcoming their predispositions may earn a hefty premium.

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