Chris Brightman, CFA

"Our beliefs are constructs that help us make sense of the capital markets."

KEY POINTS

1. Our central philosophy is that the largest and most persistent active investment opportunity arises from long-horizon mean reversion.

2. We have three core beliefs: investor preferences are broader than risk and return; prices vary around fair value; and a lack of conviction prevents investors from exploiting long-term value.

3. The long-term capital market expectations presented on our Asset Allocation website represent our best forecasts and inform our behavior within the context of our investment beliefs.

4. The beliefs underlying Research Affiliates' asset allocation models and investment strategies are admittedly fallible but have proven useful in the past and should serve well in the future.

Our Investment Beliefs

by Chris Brightman, CFA, James Masturzo, CFA, and Jonathan Treussard, Ph.D.

"Mimicking the herd invites regression to the mean (merely average performance)."

— Charlie Munger

The public launch of Research Affiliates' interactive Asset Allocation website[1] this month gives us an opportunity to describe the investment beliefs underlying our models, expected returns, and investment strategies. To be clear, our beliefs are constructs that help us make sense of the capital markets. Though grounded in theory and supported by empirical examination, they are not facts scientifically proven beyond a shadow of a doubt. Authentically admitting the fallibility of one's beliefs can be uncomfortable, especially in an industry all too often predicated on projecting unshakable confidence in predicting the future, but not to us. We prefer the honest acceptance that we (and anyone else we've come across so far) do not have perfect knowledge or information. For those willing to join us and embrace the discomfort, our beliefs draw a clear course of action that has served us well in the past and should continue to serve us well in the future.

Before describing each one of our core beliefs in their logical order, let us start at the end with our central investment philosophy:

> *The largest and most persistent active investment opportunity is long-horizon mean reversion.*

Quite simply, systematically buying assets with relatively low prices (and correspondingly high yields) and having the conviction to hold these positions over potentially extended horizons allows investors to earn higher risk-adjusted returns, albeit at significant emotional cost. This central investment philosophy is the logical conclusion sitting atop three supporting beliefs.

BELIEF ONE

Investor preferences are broader than risk and return.

The human psyche is rich and complex in ways well beyond those captured in standard finance textbooks. Yes, investors may weigh potential returns against risk. However, our experience teaches us that investors' actions are also affected by the desired safety of following the herd and the corresponding fear of being an outsider; the pride and status derived from owning stocks of successful firms and avoiding association with assets that receive negative press; the allure of gambling and positively skewed distributions; the heightened aversion to losses relative to gains; and so forth. We readily acknowledge the validity of these preferences, rather than labeling them irrational, thus moving past the stale semantic debate about market efficiency.[2]

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Our collective decades in investment management have provided us plenty of opportunities to observe these very human tendencies, and many of them are also now documented in the published works of behavioral economists.[3]

BELIEF TWO

Prices vary around fair value.

"In the short run, the market is a voting machine, but in the long run it is a weighing machine."

— Attributed to Benjamin Graham

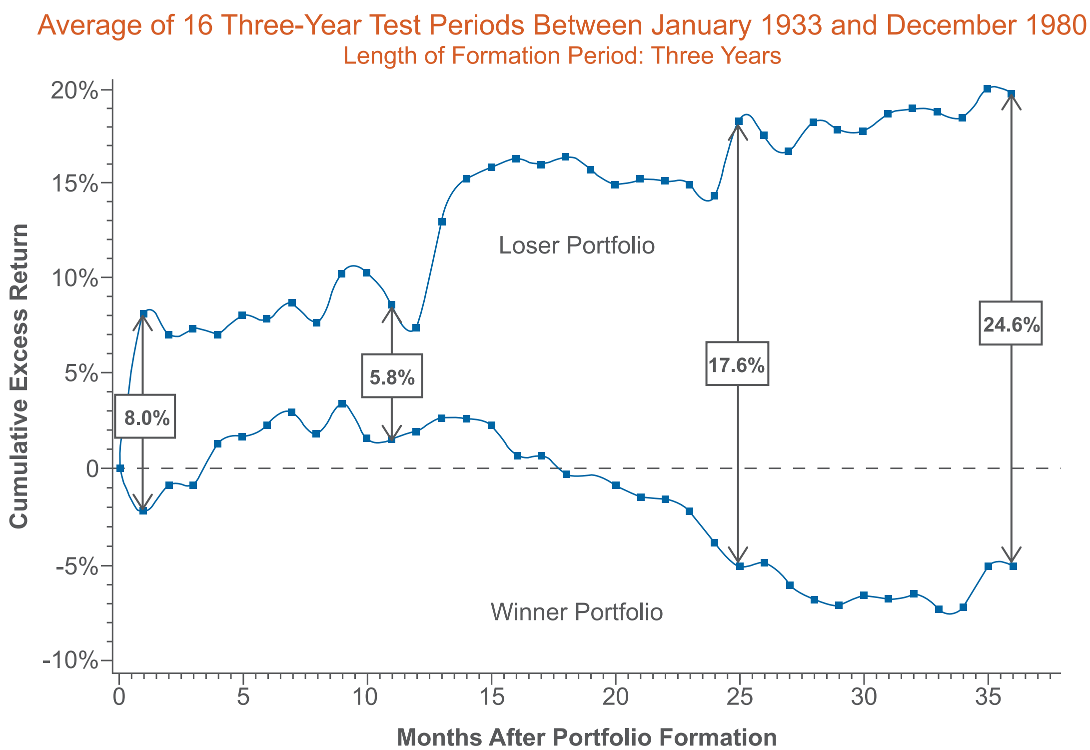
Because of the complex and time-varying preferences of investors, at any given point in time, all asset prices are not unbiased estimates of fair value. Instead, prices can, and do, materially deviate from reasonable and transparent

> *"The noise we observe is not white noise."*

estimates of intrinsic value, often for prolonged periods. That is what we mean when we say there is noise in prices.[4] But the noise we observe is not white noise, a neutral blanket containing no information. Quite the opposite: Indeed, we know far more than just current asset prices. We also know the path that prices have taken to get to their present levels. Based on this information, we can gauge which assets are likely overpriced and which are likely underpriced at the present time. Over longer periods, we expect prices to eventually revert toward estimates of intrinsic value, even as new errors in either direction are introduced. This mean-reverting process tilts the scale in favor of buying low and selling high, or at least buying low and selling at fair value!

What support can we provide for this belief? And what are the magnitudes at play, in terms of investment performance? In **Figure 1**, we reproduced De Bondt and Thaler's (1985) analysis on the future performance of recent losers and winners in equities markets. This is one of the most direct tests of noise and mean-reversion. It also happens to show dramatic results. Sorting stocks on their most recent three-year performance (and labeling them losers and winners accordingly), we see that, on average,

Figure 1. Winners and Losers



Source: Research Affiliates, based on De Bondt and Thaler (1985).

the loser portfolio outperformed the winner portfolio by nearly 25% over the following three years. Outperformance of this magnitude is not merely the cartoonist's pennies in front of a steamroller, or even the economist's $20 bills on the sidewalk. It is very large indeed.

So with such large performance spreads on the table, and with so many individuals and institutions dedicated to the management of financial assets, how can we possibly believe that we, as a firm, will not be beat to the buffet table by the large army of investment managers out there?

BELIEF THREE

Lack of conviction (and/or internal governance constraints) restrict/prohibit investors from exploiting long-term value.

> *"…it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism…. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."*
>
> *— J.M. Keynes*

Let this quote sink in for a moment, and then ask yourself: When push comes to shove, what kind of asset managers (or asset classes, or even securities) will individuals, banks, boards, and committees choose to keep investing in, especially after their strategies have disappointed over a multi-year horizon?[5] What board member or investment consultant will risk being perceived as aligning herself with unconventional and rash eccentrics after their recent track record becomes the stuff of embarrassment? It is our belief that a lack of conviction in investment choices by most individuals, and the corresponding constraints on the institutions governed by such individuals, inhibit the successful exploitation of mispricings that can be expected to correct over unknown and potentially long horizons. This individual trait and these institutional limitations help to create the opportunities that we seek to exploit.

> *"What board member will risk aligning herself with unconventional managers?"*

All of these beliefs lead us back to the conclusion: The largest and most persistent active investment opportunity is long-horizon mean reversion.

> *"Industry need not wish, and he that lives upon hopes will die fasting. There are no gains without pains."*
>
> *— Benjamin Franklin*

Therefore, great resolve—at least as much as skill or insight—is crucial in our ability to earn excess returns over time by buying assets with low prices/high yields and selling assets with high prices/low yields. This resolve allows us to stay the course and even rebalance into assets that continue to get cheaper.[6] As one can imagine, it would be difficult to tie ourselves to the mast[7] without analytical devices to make our investment beliefs operational on a daily basis, particularly a roadmap anchoring our view of what the future holds for the investment landscape. For us, part of the roadmap is Research Affiliates' long-term capital market expectations, which we recently began providing to the entire community of investors on our Asset Allocation website.

> *"Great resolve is crucial in our ability to earn excess returns over time."*

Not surprisingly, these expectations are created to directly inform our behavior within the context of our investment beliefs, and they represent our best forecast for the future. That is not to say we think asset returns over the next 10 years will be exactly the returns illustrated on our website. In fact, we are quite sure that will not be the case. However, sitting here in the second half of 2014, the data made available on the Asset Allocation part of our website are what we think of as the most probable and defensible expectations for the future. Armed with conviction around our investment beliefs and the devices needed to keep the course over time, we feel confident in our ability to help investors to earn higher risk-adjusted returns over time.

Endnotes

1. http://www.researchaffiliates.com/AssetAllocation
2. To us, we view the broader preferences of investors in the same way as those of car travelers. As made clear by alternative GPS settings, some of us prefer to take the fastest path to a destination, while others may prefer to avoid highways. In fact, the exact same person may prefer the fastest route on their daily commute and the scenic route during a vacation. None of this suggests irrationality to us.
3. Daniel Kahneman, Amos Tversky, and Richard Thaler, among many others, lay out the groundwork for much of the fields of behavioral economics and behavioral finance.
4. Our description of noise is fairly aligned with the model described by Poterba and Summers (1988), in which price is the combination of a fair value process (whose dynamics are an unpredictable random walk) and a mean-reversion process (transient noise, whose motions tend to self-correct).
5. One of us attended a meeting of university endowment managers in the aftermath of the market meltdown of 2008. We took away from this meeting the near universal desire, on the part of the institutions we were attempting to serve as investment professionals, to shed more of their exposures to depressed assets (including U.S. equities) at the exact time that a once-in-a-generation buying opportunity presented itself.
6. This is not to say that we expect every single security to mean-revert over time. There are in fact many securities that are cheap for a reason: they are just not good investments ("value traps"). This is where diversification comes into play. Indeed, we believe that making many small bets rather than betting the ranch on a single wager is good practice.
7. This reference is from Homer's Odyssey which describes the journey home of Ulysses (Greek name Odysseus) following the Trojan War. The route of the journey took Ulysses and his men past the island of the Sirens, beautiful creatures whose voices lured many sailors to shipwreck on the rocks. Ulysses made all of his men put wax in their ears to block out the Sirens' song, but he himself wants to hear and understand the song, even if it threats his sanity. To resist the Sirens' appeal, he has his men bind him to the mast, agree to ignore his orders, and keep their swords drawn on him in case he escapes his bonds.

References

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Disclosures