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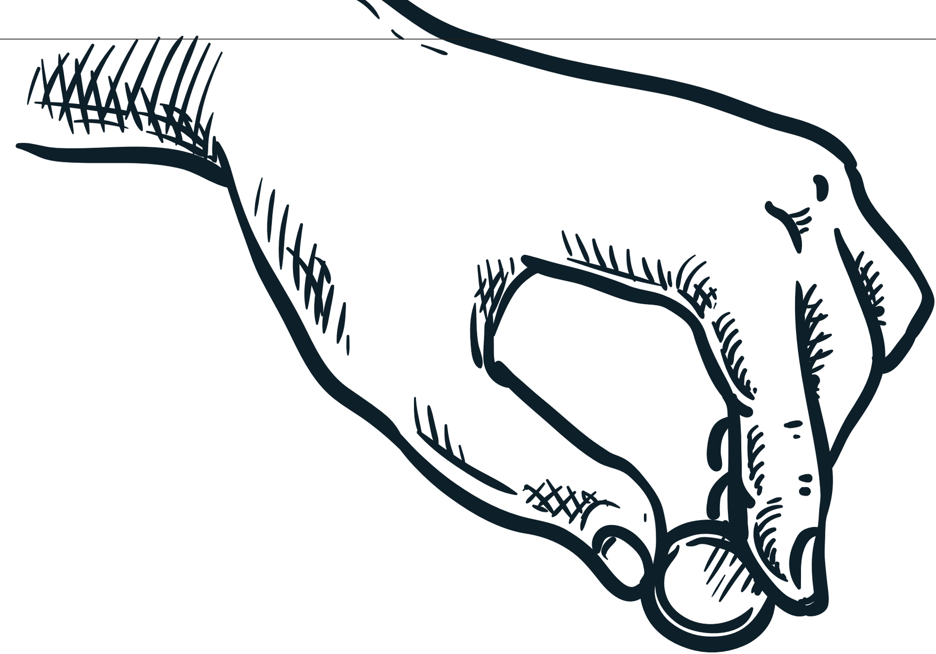
THE LONG READ



A PRESCRIPTION FOR WEALTH'S HEALTH

SHANKAR SHARMA

EVEN WARREN BUFFETT HAD TO LEARN IT THE HARD WAY, NO WONDER REGULAR INVESTORS ARE CONFUSED: WHAT ARE THE TOP HEDGES YOU NEED TO BEAR IN MIND WHILE PUTTING YOUR HARD-EARNED MONEY IN THE MARKETS?

A question I am frequently asked by investors is: "How are we to make sense of equity investing? We get so much conflicting advice!" This question is even more pertinent *now* — because the last 12 months have been bizarre. We have had no period in the last 100 years in which our health has been at more risk while our wealth, in general, has been, seemingly, less at risk.

While it is pretty simple in health terms to be safe (get vaccinated, wear a mask whenever out, etc), financial complacence is a disease which is infinitely harder to prevent and almost impossible to cure.

Let us take a stab at reducing complications and increasing awareness about risks relating to your wealth and what precautions you should take — so here's a primer on safe investing.

Asset allocation will determine most of your returns

Asset allocation basically means your investment pie chart is strategically diversified across various available asset classes. It is not just the best thing, it's the only thing. If you are just going to be a single asset (largely equity) player, then you are generally going to have a roller-coaster ride in your net worth — and, obviously, in your mental well-being.

There is research establishing that correct and tactical asset allocation can determine as much as 90 per cent of your overall eventual returns, with plenty of corroborative examples. For instance: post the 2000 tech crash, US equities halved. It was one of the worst periods of wealth destruction in recent history. However, in that very same period, a number of other asset classes, including gold, oil and US treasuries, delivered significant positive returns. Did you ever hear any financial advisor recommend that you should have a lower weightage to equities and higher weightage to gold and government debt? We know the answer already!

The general refrain you will hear is: keep buying equities. The reality is: across different periods of time in financial history, different asset classes have delivered vastly different returns, even in the very same period. In the period 2003 to 2005, commodities delivered vastly better returns than US equities. And in 2021, industrial commodities have outpaced global equities by a substantial margin. In this very period, US bonds which had a stellar 2020, have been absolutely decimated this year with the sharp rise in bond yields.

The reason for this "equities are the only thing" advice, is simple: nobody in the business of fund management or financial advice makes much or any money by recommending investments in government securities, gold or even commodities. The maximum fees are for recommending equity. "Remember XYZ stock I told you about three months ago? It is up 80 per cent since!" Sounds like familiar party conversation... or something that you watch financial channels for? If your end game is to have fun discussions at parties, this is fine. But if your purpose is to protect and multiply your wealth, or to optimise your portfolio, you are frankly approaching the problem from the wrong end. Specific stock selection, which eats up most of your/your adviser's waking hours, contributes only 10 to 15 per cent of stock market returns.

If you are investing on your own, it does not make sense to concentrate your resources and time on individual security or stock selection. But all the talk you will hear from portfolio managers is how good they are at picking stocks and bottom-up winners. The uncomfortable point is: bottom-up stock picking is a very, very difficult art and nobody in the history of investing has been able to do it successfully for decades. Yes, not even Warren Buffet. Check out his record in the past 15 or 20 years and you will see an investor who has missed practically every single multibagger that the US market has given in this period: Amazon, Netflix, Domino's, Google, Apple (he bought it well after it had become a household stock), Facebook, Microsoft etc.

The other extremely important thing is that getting the asset class right is a relatively simpler task than getting individual stock picks right. For an individual investor doing self investing, asset allocation should be the very first skill they should learn.

> Portfolio insurance is something that you must always think of — specially when investing becomes so easy
>
> Kavita Thomas

Take a portfolio approach to investing

Most investors believe taking individual stock advice — or 'tips' — from aggressive brokers, advisors, and, horror of horrors, from Twitter, and then implementing them on their own is the way to making big money.

That is a one-way ticket to financial ruin.

The reality is that all the big stock winners that we know of could not have been identified in the beginning. As we always say, "Making 100 per cent in a stock is skill. Making 1000 per cent is luck." Individual stock picking is a game in which we are carried away by the stories of people who became very rich on a certain stock. But these kind of stories are extremely dangerous because they highlight something called 'survivorship bias' — which means that we look at the survivor of a certain kind of investing style and we find one guy or two guys who made serious wealth doing it in that particular manner while ignoring the fact that probably 99.99 per cent went bust doing exactly the same thing

If you randomly pick 1,000 investors and they randomly pick a certain number of stocks, you are guaranteed to find one or two investors who become very rich. This is nothing but a simple probabilistic outcome but one that hides the fact that the vast majority will probably end up becoming reasonably poor.

Instead, take a portfolio approach to determine your equity selection. The way to find these multibaggers is to carefully select at least 25 reasonable stocks, divided into various buckets of risk and potential return. Assuming you have done some basic risk management and diversification such that you are not exposed to the vagaries of just one or two industries, at the end of a certain finite period of time (say, one or two years), 10 or 20 per cent of your investments would have become good winners while the majority will be delivering market returns. Anything between 10 to 30 per cent may also be losers.

Approach this exactly like you would approach a cricket team selection. Eliminate your bottom performers and fill those spaces with the next crop of companies you come up with. Again, after a certain period of time, you will find that the same/near-same initial list of stocks has continued to perform very well. Those are going to be your multibaggers and it is at that point that you can increase your allocation to them slightly more than where they started out from. Those are going to be Sachin Tendulkars or Diego Maradonas of your portfolio. You get them by a systematic selection process, not by a brain wave.

Biases come in our way of making rational decisions

There's a long list of biases humans suffer from. Storification bias: relying on anecdotes more than data. Recency bias: recent events unduly influence our decisions rather than events that happened earlier. Herd mentality: If everyone is saying the same thing, it must be right.

Each one of these can be tracked down to an evolutionary reason. For example, in hunter-gatherer tribes, chances of survival were higher if one moved around in groups rather than alone. Hence herd mentality became a way of life and of survival. Unfortunately, the traits that helped us survive the threats of physical environment are the same that lead us to financial suicide.

Any investor would do well to ask their financial advisor how do they avoid falling prey to these biases, and safeguard their portfolios from them.

> All behaviour, good or bad, is always driven by incentives, and equities incentivise their salespeople far more than any other asset class. Even if equities don't always deliver returns, and definitely not consistently
>
> Alok Kumar

Chew on the risk management pill daily

Prevention is always better than cure. You have heard this many times. This applies equally to wealth as it does to your health. Strong risk management is that preventive measure that can ensure you never need to go into a financial hospital. Avoiding big losses is about the closest to golden advice you can ever get.

Charles Ellis wrote a while ago that 'Investing is a Loser's Game'. What that means is that in investing whoever loses the least, wins. To illustrate, if your \$100 becomes \$65 in a market fall, you need a 50-60 per cent rise in the market to just come back to \$100. That's usually a one-to-three year journey. However, if you were able to limit your losses and fell to \$90, with a 50 per cent rise you would be up to \$135 instead of just breaking even. Big difference.

As human beings, we are not wired to making decisions that recognise pain or crystalise losses. We are happier taking pills to mask pain. Unfortunately, this approach can bring a permanent end to your investing career. And some of the most misleading advice that you hear is to keep averaging on the way down. This approach is marketed by selectively cherry-picking data.

It is always better to ruthlessly accept a loss and look for better places to deploy the remaining capital. Unless you are prepared to be brutally clinical about surgically removing losses from your portfolio, you are destined to see them grow into terminal festering wounds.

Invest in insurance against portfolio loss

We buy all kinds of insurance: life, health, car, home etc. But why don't we often hear about insurance for one of the most important assets that needs protection: our financial assets? Just like with any other type of insurance, when it comes to portfolio insurance, there's an entire spread of alternatives to choose from. What are the types of assets we want to insure? What is the extent of coverage?

Through rigorous analysis, these questions can be answered to ensure enough protection, simultaneously minimising the cost of the insurance premium. A small cost outlay can protect the portfolio during difficult times and give you immeasurable peace of mind, knowing that your portfolio is not slave to the whims and fancies of the markets. That is worth every single penny spent.

Nobody will be complaining if the portfolio anyway does well and the insurance premium that we paid goes to waste. We don't wish to fall sick just because we bought health insurance!

> Finding multibaggers is like looking for a needle in a haystack. Instead, look for several needles in several haystacks, and you are guaranteed to find your multibaggers
>
> Devina Mehra

If you want to avoid SCCARS, diversify globally

SCCARS stands for Single Country, Single Currency, Single Asset Risks. These can leave one's portfolio "SCCARd" forever. A mere glance at country-wise performance data for the last few years is eye-popping. Brazil, which was the best-performing market in 2016 (+69%), was among the worst performing countries in 2020 (-20%). The best performer in 2020 was Vietnam (+81%), which was among the worst performers in 2018 (-19%) and 2019 (-3%). Greece was the best performing market in 2019 (+46%) and was also among the top in 2017 (+41%), but it was at the bottom of the pack in 2015 (-31%) and 2018 (-27%). Similarly, Russia was among the best performers in 2016 (+53%) and 2019 (+45) but among the lowest in 2017 (-1%) and 2020 (-10%). In the 10-year period 2011-2020, US equities returned a brilliant 11.5% CAGR, whereas emerging markets equities returned a meagre 2.5% CAGR in the exact same period.

Polarisation of returns is not an aberration, it's the rule. The best performers of today can be the worst performers of tomorrow. And even within the same asset class, one part of the world can be bullish while another part is bearish. If you are not diversifying your investments across the world, the market is going to extract a very heavy price at some point. Global leadership keeps changing from year to year and there is very little persistence in trends. When you start to now look at global equities in this context you will realise how a smartly and tactically diversified global portfolio can keep your investments relevant.

(Shankar Sharma is Co-Founder & Vice Chairman of First Global, a global quantitative asset management house. Sources whose photos appear with quotes are senior members from his team. The views endorsed by the author are personal and does not reflect the opinion of Khaleej Times.)

> All humans suffer from deep-rooted biases which influence how we think and make decisions. Biases deflect us from the path of objectivity and lead in directions which are sub-optimal
>
> Achin Agarwal

THE LONG READ

Cut through the drama, follow the data

SHANKAR SHARMA

GROUND REALITY

WHY FEEL-GOOD STORIES AND ANECDOTAL REFERENCES CANNOT BUILD UP A HARD-NOSED BASKET OF INVESTMENTS

Why is it that almost all fund managers are more lyricists, less intelligent investors?

"Human beings aren't rational animals; we're rationalising animals who want to appear reasonable to ourselves," said the famous social scientist, Elliot Aronson, author of *The Social Animal*. The word around us is a bewildering medley of pure noise. In such a chaotic daily environment, the brain's protective mechanisms kick in, and takes resort in under-analysed, oversimplified, lazy opinions. The brain takes refuge in easy stories. Data and facts are given the short shrift, because the world always wants a "story".

Professional investment managers aren't robots (yet). They are human and love stories. And stories sell. With greater amounts of data being available, the need to "storify" has increased even more. When a fund manager paints a superficial yet magnificent vision of why a particular management has a Midas touch, it is almost always a 'story', that has been airbrushed so perfectly that no other room for interpretation, or no other future trajectory can even be mentioned, for fear of attracting contempt. Remember how one could never question IBM, as a stock, at a distant point in history?

So why is a strategy based on 'storification' so risky for investors?

Because when a fund manager gives their holdings a golden future, they ignore discordant, inconvenient, conflicting elements (industry cycle, favourable policy, plain luck). In other words, they ignore the risks inherent in every single company or industry on this planet.

Storification is dangerous because it paints a risk-free world; unfortunately, there is no such thing as a risk-free world. True investment greatness is knowing deeply all risks present in a given investment, and then deciding what is acceptable risk and what is unacceptable risk. Storification, on the other hand, increases attachment to that story. Once an investor or fund manager becomes emotionally invested to a particular stock (eg, ARK Investment to Tesla), they find it impossible to detach themselves from their attachment, even when the facts change.

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Love in investing is dangerous. This is exactly what happened with Warren Buffett and his Coca-Cola investment. He should have sold this stock several years before he actually did. The data is brutal: Coke has been a rabid underperformer since 1993. Buffett should have bought Pepsi instead of Coke. He couldn't sell because he had storified this stock and its management massively.

In India, you would have heard the talk that you cannot go wrong buying 'blue chips' or consumer stocks with strong brands, moats and cash flows that are predictable for decades. This story is seductive. And untrue. Heard of Gillette India, ITC and Colgate? They used to be part of this list of storied, branded consumer companies. Then their stories went sour, and, very quietly, they went out of the list of these so-called compounders.

When Steve Jobs died, Bill Gates said, "Steve and I will always get more credit than we deserve, because otherwise the story gets too complicated." Which brings us to the next point: should you dismiss a story only when it is based on no facts at all? Actually, the really dangerous stories are the ones that are true in one tiny part, where a small bit of truth is used to build a whole edifice.

In investing, there are always known unknowns. Fashion changes, health trends, new product disruptions, policy changes, etc. Things are rarely linear in real life for a large basket of companies. But they will always appear to be linear for company selected with complete hindsight or a selection of the survivors.

Based on these survivors, a vision of the future is painted in which absolutely everything is perfect, whereas the reality is that, beyond a point nobody, knows anything about anything. Neither company management nor fund managers have any clue about what happens a few months down, let alone years.

All this means that the key to being a good investor is being alert and flexible, rather than being married to a story you have built up in your mind. Always follow the data.