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The story behind our high-conviction stock ideas

Synopsis
All studies and data have shown that while human beings love stories, storification is one of the systematic biases that bring down investment returns.

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Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

First Global has since become a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds.

She has been quoted widely on Global as well as Indian markets by global financial media like Wall Street Journal, Barron's, Business Week, Fortune, Forbes, CNBC, Financial Times etc.

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Recently one of the large banks which is in the process of starting distribution of our products asked for the 'stories' and narratives behind why we have bought certain stocks or exited them. Plus they wanted to understand our high conviction ideas.

The issue we face?

Our whole investment process is anti-storification and anti-high conviction - deliberately, consciously and systematically so.

All studies and data have shown that while human beings love stories, storification is one of the systematic biases that bring down investment returns.

It is a trap that all of us are very prone to because stories are, in a real sense, what makes us human.

The one thing that is common across all human civilizations across the ages and across geographies is that we are storytellers: we communicate through stories, we remember stories, we are moved by stories and we teach through stories.

What that means is that not having stories is a disadvantage when you are trying to convince a human being, whether it is a lay investor or even an investment professional (it is just not as satisfying without stories, is it?).

"Human beings aren't rational animals; we're rationalizing animals who want to appear reasonable to ourselves", said the famous social scientist, Elliot Aronson, author of 'The Social Animal'.

But when you are trying to outperform the market, going by data instead of stories is what gives you the results.

Hence our entire investment process is geared to take advantage of this truth: The only way to win in the markets is to go by data, not stories.

In theory, we all want to say that we make investment decisions based on data but if I tell you that we bought a particular stock because the return ratios were expanding, growth across quarters was consistent, asset utilisation was the best in class, it had no apparent corporate governance issues etc and it was in the top 10% in most of the factors that we like to look at, it does not sound as exciting as a story of great brand, visionary management, or huge orders in the future etc.

As human beings we do not want dry data and statistics, we want juicy stories - that is exactly how the market entraps us.

Because the market is not a human being and does not mind breaking our heart over our carefully crafted story.

The data-based approach that has served us very well and the results are there for all of you to see whereby we are the top performing Multi cap PMS since our launch and the gap on the risk adjusted return measures is even higher.

By not attaching conviction and therefore emotion to our ideas, we have been able to move in and out of sectors and stocks far ahead of the market.

For example, we went overweight in Industrials and Capital Goods based on our systems way back in October 2021 when most fund managers began to understand and tell that story only in 2023!

While that sector had been a dog for 12 years from 2009 to 2021, the fundamentals were changing because of the order book and sales pickup. Plus the many lean years had resulted in cost efficiencies so once the business came in, the margins were beginning to expand.

For many fund managers, it remained in the dog category for many more quarters and their investors missed the major move in the stocks. Because, for human beings it is very hard to change the stories they have formed in their heads.

At a time when everyone has now started to pile into the sector, we are evaluating whether that story has run its course or not. Till now our systems have not signaled the reversal, but we continue to watch and evaluate.

Similarly, when FMCG was the story being sold throughout 2020, we were among the few fund houses to say that it did not make sense to us, based on data.

On the other hand, almost the first FMCG stock recommended by our systems was ITC which we bought in early 2021 and which became a huge winner for us because we had no bias against it.

Ironically, a number of fund managers who were proponents of the FMCG story never bought ITC, at least in the initial part of the move - because they were wedded to their old stories.

A system is designed to get rid of human bias, as well as noise, that is introduced anytime human beings are making judgements and decisions.

As Daniel Kahnemann says, "A well-designed system will always outperform a human expert."

To give another example, we evaluate all our holdings on a zero base every quarter - essentially answering the question that if we had cash today where would we be invested. This is to get rid of Endowment bias that makes us hold on to things when there are better opportunities available in the market.

The worst thing about storification is that in the end it misleads not just the listener but also the storyteller!

The narrator repeats the story so many times that they also begin to believe it. And the best among us fall prey to this!

The legendary Warren Buffett did too, with one of his most well-known picks: Coca-Cola.

Renowned though it may be, a closer look at the numbers over the 30 years, since 1993, tells a different story — while Coca-Cola's stock multiplied 11 times, it trails way behind the S&P 500's 18-fold increase and Pepsi's 15-fold surge.

But because Buffett had told the story of why he bought Coke and why Coke was such a great investment so many times, even he could not foresee or act on its huge underperformance.

As for high conviction, what better example than that the companies profiled in 'In Search of Excellence' and 'Good to Great' were UNDERPERFORMERS compared to the S&P 500 basket, in the decade after the publication of the books - not just in terms of stock performance but even sales and profit growth.

Even when we look at the list of the top contributors to our PMS performance in each calendar year, we find that we don’t hold many of these stocks anymore. For example the chemical stocks that were our top performers in 2020 and part of 2021 are no longer part of our portfolio.

If we had gotten married to these stocks by telling ourselves great stories about these stocks, we wouldn’t have been able to get out in time!

Stories can always be found to justify why a stock or even a company's performance is great at a point and time but most of it is just a justification for what is happening right now.

How many people even remember that Cisco was the highest market cap company in the whole world once upon a time and was the most coveted investment? Or the dream run of ABB? Not to mention Enron.

Plenty of such examples in the Indian market too. The initial Sensex list had textiles, shipping, Premier Automobiles, Hindustan Motors and groups like Mafatlal, JK, Thapars, Scindias et cetera dominating - all of whom have been consigned to history now.

At one point the major indexes had zero weightage for banks and financials - now those are the highest weight. On the other hand, there were 7-8 PSUs in the Sensex at one time.

Fashions, performance, themes, narratives all come and go.

And it is also another human bias to forget what we were actually thinking and narrating once the time and facts have changed. Hindsight bias makes us believe that we always knew what was going to happen.

That's the data!

Rest are, you've guessed it, stories.