Creativity and predictability are key for alpha generation

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In everyday life, ease of use and predictability are virtues that we all embrace. The success of Apple products, with their easy to use software and narrow range of product choices is a particularly good example of these virtues having been translated into commercial success. This desire for simplification is no different when presented with the challenge of picking companies amongst the complexity of the equity markets.

These outcomes are not surprising given typical human behaviours, several of which will be highlighted in more detail in this paper. However, the more the allure of a particular financial solution due to its predictability and simplicity, the more there is a reasonable probability that it is already being recognised and owned by other investors, as well. It should be no surprise to experienced investors that this is not typically the condition for excess returns. Uncertainty and indeed dispute are more often preconditions for superior returns when the specific goal is to outwit other investors and beat the market.

Investors need to balance the desire for an investment process that provides reasonably predictable outcomes over the long term but equally also exploits uncertainty and its associated volatility over the short term. This balance is more likely to be achieved where the manager has suitable time horizons, is adaptive to change, and is not dictated by the collective behaviours of the industry.

WHY THE ALLURE OF PREDICTABILITY IS DRIVING BEHAVIOURS

Behavioural investing is not a new topic and has been comprehensively covered by a variety of writers – so here it is assumed that the reader has a working knowledge of main biases that can prevail. There are a few that would appear to be relevant to the current environment.

Representativeness

Representativeness refers to the ability to be dictated by how things appear rather than how they are. This heuristic was first written about by Tversky and Kahneman back in 1972[1], and is relevant today when considering active management. The rhetoric in the financial press and the focus on average managers (or an available dataset such as mutual funds) has created a perception that active managers underperform and passive investment is the cure for this malaise. Cremers and Petajisto (2009)[2] and Cremers (2017)[3] would, however, suggest that high active share managers on average do not fit this accepted wisdom.

Framing – or more specifically, Inattential Blindness

This was described eloquently by Simons and Chabris in 1999[4] in their Gorilla Test, which showed the inability for many to even notice its presence when counting the basketball throws.

Figure 1: The Gorilla Test

In the investment context, the significant focus by many researchers on managers' ability to deliver predictable outcomes, and particularly along the lines of investment style, may be obscuring them to the importance of skill in delivering the active returns they seek.

Confirmation bias

The simplification that passive or more prescriptive style solutions provide is no doubt associated with the increasing focus by investors on tools to analyse financial returns. This includes back tests, algorithms, machine learning, risk modelling and the like. Data to support the investment proposal helps confirm that the outcome will be predictable.

There are likely to be other behaviours that could of course be used (or tortured, if you are a non-believer) to support the thesis, but to ensure brevity, it is as follows:

> The desire for predictability is conditioning investors to focus on or look for linear/simple solutions (passive, smart beta, factor specific ETF's etc) and to be anchored around what has been demonstrably working in more recent times according to the data. Seasoned stock pickers typically have experienced this in their careers when they have observed the moth around the candle when market darlings dominate index returns. "I cannot afford not to own it" have been seven very expensive words for many active investors.

What may be being ignored as a result of these behaviours is the following:

- Financial markets are complex. This is particularly so at the stock level and there is always a wide dispersion of outcomes when the opportunity set is large such as in global equities.
- Human minds may default to simplicity but when applied correctly can compute the complexity highlighted above much more effectively than computers when change and new factors are introduced. Disruptive technology is a good example and the modelled mean reversion of newspaper companies or high street retailers has been rather illusory.
- Creativity is therefore to be embraced when picking stocks, not avoided. This can also be described as human skill, and while undeniably variable in nature and less predictable over shorter time horizons, is a source of return that is idiosyncratic in nature.

Hence, optimal outcomes when seeking excess returns from active investors will found when there is a good balance of their ability to deliver both creativity AND predictability. Industry behaviours are skewing decisions towards the latter, with the market share of passive investing being a good indicator. The assessment of creativity amongst managers is no different from the challenges of picking stocks, but similarly there are some criteria that can help with this quality assessment.

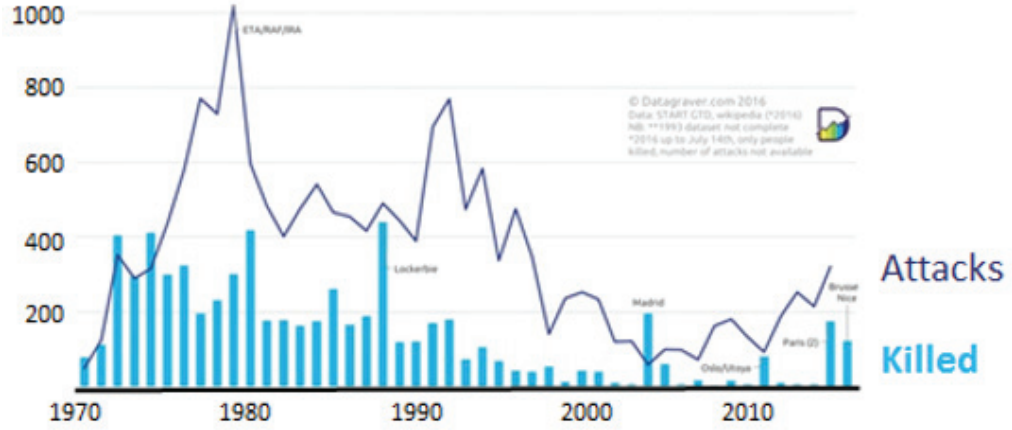
CRITERIA FOR ASSESSING CREATIVITY AMONGST MANAGERS

1. Time horizon

Recency is powerful in driving decision making, and anchoring around recent news is something we are all vulnerable to doing. How the prevalence of instant news and social media will effect this over time will be an interesting debate – but the initial reaction is that it will only compound this effect.

There are some excellent resources such as Gapminder that are good at illustrating this effect. Take for example the public perception of the prevalence of terrorism, which many think is high by historical standards. In fact, the reality is the exact opposite as shown in Figure 2.

Figure 2: Terrorism in Western Europe 1970-2016



Source: CC-BY GAPMINDER.ORG

Stock pickers need to have the ability to genuinely invest for the long term and have the ability to weather the volatility that will no doubt prevail over shorter periods

2. Assessment of change

Framing around what matters to markets according to commentators can make them blind to change. The writer of this paper remembers well that the US trade deficit was a key market moving event early in his career (which started in August 1987) but is currently background noise in current markets versus the launch date for the Tesla 3 model.

Highlighting new themes such AI, machine learning, autonomous vehicles as examples of change, rather feels like stating the obvious given the degree that they have been dominating headlines. The impact of these trends on both economies, markets and societies should certainly not be underestimated, but we would suggest that such disruptive shifts are, in reality, business as usual. Blind extrapolation is equally nothing new, and the ability to quickly package such themes into an available financial product does not necessarily equate to wise investment.

Stock pickers need to embrace change as it can have a significant impact on differentiating between companies, particularly when cyclicality in monetary policy is limited (for now anyway). The behaviours of investors in allocating capital aggressively to new trends can lead to valuation divergences which often provide opportunities at exactly the same time as the cheap money it entails creates a supply driven downturn.

3. Market conditioning

Benchmarking and price trends are dominant inputs on a daily basis for most asset managers. However, identifying changes in these market trends is certainly not easy, with hindsight bias undoubtedly contributing to investors' belief that they can do so. Hence undertaking strong calls in this regard is less wise.

However being "Foxy" as suggested by Nate Silver in his book "The signal and the noise" is wholly appropriate. Nate describes foxes as being those "who believe in a plethora of little ideas and in taking a multitude of approaches toward a problem. They tend to be more tolerant of nuance, uncertainty, complexity and dissenting opinion".

The foxy view would focus on the following as themes that may increasingly develop in the future:

- QE and cheap capital and the period for which it will endure. The acceptance of cheap car leases as the new norm is a good example. The ability of ever increasing government debt to be sustained by low interest rates is another.
- Political promises. Voters and politicians alike have a weak understanding of the "dismal science" on average, and this can allow electoral promises to be converted into policies, despite the lessons from history suggesting this is an unwise route.
- Episodic volatility. Daniel Kahneman in his book "Thinking fast and slow" eloquently describes System 1 and System 2 type thinking. Recent history would suggest that volatility is not a constant but is in fact rather episodic in nature, and it is during these events that system 1 type thinking can dominate. Staying foxy and more detached with System 2 thinking is key to being able to exploit such events as opportunities. With volatility at almost unprecedented low levels, this key test may be ahead.

4. Mindset

How do you have an opinion without data? If you started your career in the 1980s, you may remember market reports arriving in the form of a telex – at the end of the day. More data does not necessarily equate to better decisions, and indeed may promote some of the shorter term behaviours highlighted above.

Data dependency

The paradox when picking stocks is that the availability of data to support an investment rationale, when obtained through appropriate channels, is likely to also be available to other investors and distributed at the same time. The mining of financial statements, given the

increasing efficiency in dissemination, has become more of a bulk commodity than a rare ore body. Assessing what is not being said is a more difficult algorithm to create.

Humility

Forecasting and picking stocks is not easy, and making mistakes within a portfolio of decisions has to be embraced. Just as golfers don't dwell on the bad shots but rather use them solely as learning experiences, the howler of a stock call is no different. Experience would suggest that certain decisions are more likely to humble you than those with wrinkles on them.

> "Stay hungry, stay young, stay foolish, stay curious, and above all, stay humble because just when you think you got all the answers, is the moment when some bitter twist of fate in the universe will remind you that you very don't." – Tom Hiddleston.

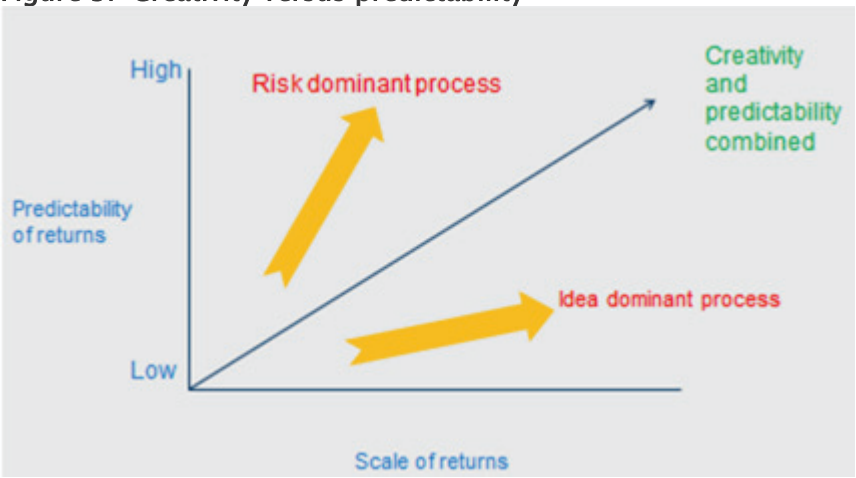
ACTIVE INVESTING NEEDS TO EMBRACE BOTH CREATIVITY AND PREDICTABILITY

When selecting an active manager, there is a yin and a yang to consider.

Manager choice based solely on highly predictable outcomes is typically likely to deliver the commensurate lower returns, or where returns are high they are based on factors that are not dictated by manager skill and the persistence of these factors is paramount.

Manager skill (creativity) can also deliver notably different returns when suitable risk is taken (high active share). However, the dispersion of such outcomes can be frustratingly large, in part due to the fallibility of such skills, making predictability of outcomes quite difficult.

Figure 3: Creativity versus predictability



Source: Nikko Asset Management

The solution is to balance the competing demands of returns (manager creativity) with the risk (manager predictability). In essence, getting people and process correct, which is of course a not surprising statement. The more important conclusion however is that the selection process is prone to being skewed by the desire for predictability.

This can be mitigated by firstly focusing as much on the creative part of the active process and, in doing so, focusing on the following:

- Investment time horizon – should be long;
- Ability to incorporate change – pragmatism rather than prescription;
- Market conditioning – independence of thought is essential both within teams and for the strategy as a whole; and,
- Behaviours – data dependency can be a curse rather than a cure. Be smart rather than become a second rate algorithm.

Secondly, the predictability of a manager may also be enhanced by the following:

- Experience – skill in selection and implementing over long term horizon;
- Investment criteria – defined investment parameters that shape typical portfolio outcomes; and,
- Team behaviours – process that embraces and maximises human skills.

All of the above is important when picking individual stocks and creating active portfolios. It would seem appropriate to apply the same logic to manager selection. The outcome of selecting an active management strategy will likely be greater when both the creativity and predictability of the candidate are considered in equal measure. In addition, the contribution to the overall portfolio may become more idiosyncratic and hence likely to be a worthy component of "It all adds up".

ENDNOTES

1. Daniel Kahneman and Amos Tversky, "Subjective Probability: A judgment of Representativeness", *Cognitive Psychology*, 1972

2. Cremers, Martijn, and Antti Petajisto. 2009. “How Active Is Your Fund Manager? A New Measure That Predicts Performance.” *Review of Financial Studies*, vol. 22, no. 9 (September): 3329–3365.

3. Martijn Cemers, "Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity", *Financial Analysts Journal*, 2017

4. Daniel J Simons, Christopher F Chabris, "Gorillas in our midst: sustained inattentional blindness for dynamic events", *Perception*, 1999

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