

# CHAPTER 1

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## Introduction

### Experts and Evidence

Investing in shares is challenging, even for experts, and it will always be so. This is because the movement of a share price and the eventual returns a share is able to provide are the result of a myriad of different influences (international, macro-economic, government actions, analysts' forecasts, general news, the actions of the company – to name but a few). At any one point in time, it is unclear how these various forces will come together and affect a share price and, even in the longer term, where there is a hope that the performance of the underlying company will shine through, there are lots of uncertainties and irrationalities that can bounce a share price in a downward (or upward) direction. At the time of writing this first chapter (May 2020 – as you will see throughout the book, different chapters have been written during different periods and we have decided to keep these time differences to illustrate how the world of investing is extremely dynamic, to say the least), the world is coming to terms with the economic consequences of Covid-19. In the UK, we are facing the biggest drop in GDP (possibly 25% – on 11 June 2020 it was announced that GDP in April had fallen by 20.4%, the biggest one-month drop ever recorded, and the FTSE 100 barely moved on the back of the announcement!!!) since the Great Frost of 1709.

However, we are getting ahead of ourselves (and we do this occasionally throughout the book when the logic/excitement of the argument takes hold) and we need to explain why investing can be rewarding and fun, albeit challenging. But before we do this, we should give you a bit of background on

ourselves. Well, we are a couple of finance professors who also run investment portfolios and we have been doing both of these for six decades across the pair of us. You would have thought by now we would have all the answers but this is far from the case. Investing is always a challenge and there is always something to learn, shocks to deal with, and surprises to enjoy. This is why we have continued to teach and practise finance for such a length of time. In terms of the practice, we have learnt approaches and lessons that can be passed on to good effect – While not one of them is 100% foolproof, they should act as good guides and prevent too many costly mistakes. Our academic lives have given us the time and resources to analyse and reflect on a whole range of different approaches – their shortcomings and strengths. Furthermore, we do not have any axes to grind or services to sell – our advice is impartial.

This is not the first book we have written on share dealing. We wrote one back in 1998 to launch the Halifax share dealing service. This book was intended as a simple primer for people new to the world of financial markets and shares. It was also written in a different (pre-internet) era where access to the markets was not as easy and there was a lot less financial information and fewer computer programs to undertake any analysis. Essentially, we are now in a different world for the ‘part-time’ investor. Having said that, the information and analysis available do differ across different types of investors – professional investors having everything at their fingertips on a second-by-second basis, students having excellent access to online datasets and analytical programs, through to the amateur investor on a laptop in a bedroom. Even the last of these still has access to data and programs that were only a glint in the eye before the internet. And, possibly, most importantly, minute-by-minute business and financial news is available to everyone; this can be a blessing but it can also be a curse because a lot of the news is just noise, speculation, opinion, etc. and it can blind the investor to what is really going on. The stock markets are currently riding high in the midst of the biggest crisis the globe has seen for many a year. They are being driven by the cash being washed into the system via government and central bank actions, and the premise seems to be that the economies will benefit from a sharp recovery. We have our doubts, given the damage done to a lot of sectors, the record increases in unemployment and the changed (reduced) behaviours consequent on the Covid-19 virus (will a service economy bounce back, given all the fears and uncertainties?).

This moves us on to who this book is aimed at. It is not intended to be a primer for those new to the financial markets, many of those already exist. Nor is it intended to be an in-depth guide to a particular investment approach.

Instead, it is intended to introduce a range of investment approaches that have seen great success in the hands of individual experts. Some of the approaches are complementary, others are not. More importantly, lessons can be learned from each of the approaches and some can be combined to form a unique approach to fit the interests and attitudes of an individual investor. We have given a reasonable amount of background on each of the experts as this helps to understand the context of the successes and what might be required to make them work. Each chapter also gives small insights to make you sit back and think – i.e. do I have the patience to make this work?, do I have the funds?, is the market the same?, have such gains now been competed away, etc.? Given all this, the book is aimed at students and, to a lesser degree, interested amateurs (see the next paragraph) – these are the ones who have the potential to benefit from the approach taken here and this moves us on to the next, key feature of this book.

While the book is concerned with looking at the lessons to be learnt from investment experts, it is also interested in presenting relevant evidence on the approach (i.e. what could have been achieved by an approach over recent years). The presentation of evidence has two questions:

1. Do the claims of an expert now stack up?
2. How might an approach be quantified so it can be tested against data?

This allows the reader to look at an approach and shows how it can be applied to modern data and techniques of testing. The evidence in each of the chapters is a prelude to the Practical Applications that accompany each chapter. The Practical Applications are a step-by-step guide to actioning a strategy that replicates that of an expert – not always perfectly but as close as we are able to. The intention being that by the end of the book, students and investors will be comfortable with accessing data and developing customised investment strategies.

Through teaching quantitative methods and its many constituent parts, we have found it is best to give a bit of a feel for the theory and then to quickly follow this with practical examples students can work through. There is no replacement for learning by doing. The ‘doing’ allows the students to understand the intricacies of an approach, the key assumptions, what needs to be done to apply an approach and how it might be ‘sensibly’ tested – this is not as obvious as it might seem at first glance. Only by trying to apply an approach can an investor begin to appreciate its strengths and weaknesses. So, while the

approaches of the various investment experts can be read on their own, the real ‘wins’ will be gained through trying to apply them to data.

### THE PHILOSOPHY AND STRUCTURE OF THE BOOK AND ITS CHAPTERS

Novels are often best read through a series of sittings not too distant from each other; too distant and characters become muddled, as does the plot, and this is especially the case in some crime novels when there are a number of interwoven subplots. This book is almost the reverse. Each chapter is largely self-contained and should be approached in a singular, focused manner (this sounds a bit heavy and it is not intended to be) and be seen as a starting point for exploring a particular approach to investing. The structure and style of each chapter are intended to whet the appetite of the reader and encourage further exploration. In other words, each chapter is not the end to learning an investment style but purely the beginning. The chapters should be seen as guides, simple highlights, focusing on the key elements and giving impetus to further reading and research. As we noted above, we have been doing this a long time and we keep on learning and exploring on a daily basis. To take an art metaphor, it is easy to understand the broad approach of an artist but it normally takes a lifetime to appreciate the intricacies of an artist and become something approaching an expert – just consider how many so-called art experts are fooled by forgeries/forgers.

To achieve the above objectives, each chapter has a common structure, with a few exceptions, given the specifics of a particular investment expert. After a brief introduction, each chapter has a **background** section on an expert. The intention here is to give a bit of colour and interest and, more importantly, the context of an expert. The particular style of an expert is often determined by their history and specific experiences, noting a number of the experts lived through many of the economic/financial trials and tribulations of the twentieth century. Experiencing a great depression must leave a lasting impression, as will living through the nightmare of Covid-19. Seeing the consequences of rampant speculation and betting on a market driven by the sheer volume of cash and speculation, rather than fundamental value, is bound to leave a taste for value, growth, and a contrarian perspective to investing. A number of the background sections clearly show how an expert’s experience has had an influence on the nature of their investment philosophy. However,

it is important to remember these sections just give brief highlights and there are a lot more insights to be gained by wider reading, and for most of the experts there is no shortage of reading material – with some having many books and articles about their lives and investment philosophies/successes/failures. What does shine through a number of the background sections is that the investment styles of experts often mirror their personalities and this needs to be borne in mind when considering your own approach – there is little point in trying to adopt a cautious, long-term value approach if you are a natural risk taker who enjoys the short-term ups and downs of gambles. The other characteristic that also shines through is the determination of the experts and the willingness to pick themselves up, again and again.

Once some interest has hopefully been gained in an expert through the background section, we then move on to describe their **key lessons**. The key lessons of an expert are our distillation of their fundamental insights. For example, let's take Warren Buffett (see Chapter 2), who has had many books and hundreds of thousands of words written about him and his investment philosophy. His approach is essentially very simple in outline but downright difficult to apply in practice. There are only three key lessons to Buffett's approach:

1. Understand the value of a stock (i.e. understand its fundamental investment value of the company and not its stock price/return based on speculation). At the moment of writing (June 2020), we are seeing a massive dislocation between underlying company values and their stock prices. The latter being driven by money being pumped into the system by central banks to counteract the effects of the Covid-19 virus. But a large number of companies are facing very difficult futures through massively restructured markets, dysfunctional supply chains, a reluctance to invest, and a reluctance to consume. Buffett, and a number of other Wall Street experts, have stated this is biggest dislocation between underlying corporate value and stock prices they have ever seen.
2. When purchasing any asset, attention needs to be given to its liquidity, i.e. the ease of disposing of the asset at not too great a loss. We have experienced this issue a number of times in our lives. Let's take the case of yachts. They are incredibly easy to buy but you try selling one. The market (excuse the weak pun) is extremely illiquid. It can take months and years to sell a yacht and many languish unsold for an inordinate length of time. It often takes a significant price reduction from the

‘market price’ to sell a yacht and this is the definition of an illiquid asset. Another asset that currently springs to mind is French chateaus. To the British investor, they look to offer remarkable value (not surprising given the prices in the British housing market) but there are normally good reasons why assets are priced at a specific level (ignoring speculation and bubbles). French chateaus suffer from the three obvious problems of very expensive repair and maintenance, a difficult-to-navigate state bureaucracy, and a complex tax system in terms of assets. Not surprisingly, these assets are difficult to sell and at the moment of writing, their prices are dropping significantly – even allowing for the TV programmes portraying their many advantages. These are definitely assets of the heart rather than the head.

3. Buffett is cautious and he demands a margin of safety between the fundamental value of a company and the price that is being asked for it. What level of safety is required will depend on the nature of the asset and its liquidity.

So, the key lessons of Buffett are fairly simple but their application is not so straightforward. However, with a bit of common sense it is possible to move some way towards the Buffett approach and that of the other experts. For example, and keeping with Buffett, we will describe how he is a cautious investor, as mirrored by the above key lessons. Therefore, he will want to consider companies that have a good information set on which to base his analysis. This means avoiding small companies and recent flotations (initial public offerings, IPOs) because the information is likely to be patchy and not always reliable. Buffett also wants to invest in solid performers, so here you could put in place some form of profit filter across a given time period and some measures of balance sheet strength.

Having explained the key lessons and application of an expert, we then look at the existing empirical **evidence**. We can again illustrate this with the example of Buffett in Chapter 2. The empirical evidence of Buffett’s direct performance is relatively limited apart from the fact that he has made a lot of money for himself and the investors in his Berkshire Hathaway investment vehicle. But even here there is the argument that any investment approach will have a distribution of success, and Buffett’s is just an extreme observation. He rightly counters this argument with the longevity of his success – no one beats the market every year, so there must be something underpinning an approach that generates extremely positive returns decade after decade.

Due to existing empirical evidence often being limited, we provide our own quantitative assessment of an expert's approach on common datasets covering the US, the UK, and China. The common datasets allow us to compare the performance of the different experts discussed, but we need to accept that not all approaches are equally quantifiable and testable. Allowing for this caveat, we show that Buffett's approach, as quantified by us, achieved a cumulative return across the period 2004–2018 almost double that of a market benchmark – noting that with the exception of the Global Financial Crisis of 2007–2008, the markets have experienced one of the longest bull runs in financial history.

Of course, no expert is free from error and all of the ones discussed in this book have made major errors of judgement. We discuss the major (published) **mistakes** of each of the experts to see what can be learned. What is interesting is that the errors normally occur because the expert strayed from their own strict guidelines – showing it is difficult to maintain an approach when confronted with a range of opportunities and lots of conflicting data/information. In addition, each of the mistakes offers an insight on their own. For example, Buffett's mistimed investment in Tesco. His normal approach is to invest only in what he understands but he broke this rule with this investment because he did not appreciate the changing landscape of the UK grocery sector with the surge of the low-cost entrants, such as Aldi and Lidl.

After a brief conclusion, each chapter proceeds to a section describing how the approach of a specific expert can be applied and backtested. In Chapter 2 on Buffett, the Practical Application section describes some general matters, given this is the first expert chapter, of equity screening; for example, what should be the sample of companies and whether absolute or relative metrics should be used when considering the various filters applied to a given expert. Once these general issues have been discussed, Chapter 2 follows the pattern of all chapters and describes a worked example step-by-step. While the chapters are intended to be largely stand-alone, understanding how to apply various steps and filters will build up as the chapters are worked through. Once a given expert's approach has been built up, the final part of the chapter is the Practical Application section to show how to backtest and see how the approach has performed across various samples and time periods.

The Practical Application sections are critical to understanding an approach. Only by trying to apply an approach, can its intricacies, strengths, weaknesses, etc. be understood. It also gives readers the fun of tweaking an approach and seeing how its performance changes across different samples

and time periods. With reflection, this is a quick and analytical means of gaining insights – just as much as watching the market and reading the financial news on a daily basis. Remember, no approach is ever the ‘finished article’ as the markets and its participants change through time – this is what makes the subject exciting and, hopefully, rewarding. An open mind and lots of reflection through testing are the only methodical ways to achieve ongoing success.

## THE ROLE OF DATA AND TESTING

We connect experts’ investment lessons with data in two ways. First, data enable us to produce evidence to evaluate and understand an expert’s investment approach. This gives us a tangible idea of how great some of these investment achievements are but also allows us to appreciate the diversity of paths that one can take to get there. Second, data are the new fuel in the digital economy. We are connecting traditional philosophies with future developments in mind. To understand the relevance of those investment ideas to current and future investment environments, we need to reconsider the increasingly important role that data play in the economy and how we can harness the power of easy access to data for our investments.

To turn data into useful information, we need analytical tools that fit the purpose. As we will learn in Chapter 8 on Quants, complex computer algorithms are used to connect with millions of data points to produce an automated trading system. It was only possible to develop such systems in the past by bespoke software design and proprietary access to some hand-collected data. The internet has lowered the costs and technology development has enabled the collection of unstructured data (images, video) from many different sources (satellite images). Vast quantities of these data are released in real time. The traditional approach of watching the news and reacting is gradually being replaced by an algorithm to monitor the abnormal flow and tone of the news.

The ideas and techniques introduced in this book can be implemented via many data environments and we will use a few to illustrate the power of a structured, data-driven approach to developing and testing investment strategies.