

Volume 27

Noisrevni: The Art of
Inversion

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NOISREVNI: THE ART OF INVERSION

How can you ensure the worst possible investment returns?

An unlikely question, to be sure. But often the best insights are gained by approaching a problem through an inverted lens. The approach has been utilized successfully by Carl Gustav Jacob Jacobi, Johnny Carson and Charlie Munger. As Jacobi would say, “invert, always invert.”

“If you knew where you were going to die, you would never go there.”¹ Likewise, to avoid death in the investment world, you must know what it looks like.

Investment death is simple; it comes from portfolios with low expected returns where the risk of permanently impairing capital is high. A lottery ticket is the perfect analogy: the expected return is less than what is paid, and the risk profile provides a very high probability of permanent capital impairment. How much can you sell an old lottery ticket for?

Charlie Munger, a master in the art of inversion, once made an enlightened commencement speech based on one originally done by Johnny Carson, on “How to lead a miserable life” This article is written in homage to their efforts and prescribes the actions required to achieve a miserable investment portfolio. The aim is to help readers invert their thinking and avoid investment death. We hope readers are more successful investors as a result.

How to Earn Bad Returns

1. Restrict yourself to the smallest investment universe possible.

Limit your opportunity set, so that you reduce the chance of finding true bargains. It is wise for investment managers to organize themselves so that capital is allocated in narrow silos. Specifically, have analysts allocate time between a handful of stocks in a single industry, in a single country, providing buy and sell recommendations on a relative basis. This narrow focus will ensure that capital will be over-allocated to poor industries and under-allocated to ones with many opportunities.

Do not diversify geographically. Dismal returns are easier to earn when portfolios are locally concentrated. If the investor resides in a developed country, this approach will limit exposure to developing economies that are faster-growing, circumventing greater expected returns. Thankfully, most people have a home bias, so you will not have to spend time convincing clients to invest abroad.

1 Charlie Munger

Investing in only one country ensures the full exposure to the risks associated with that country. It is a head start towards significant black swan risk (or your very own Iceland scenario). This way, an investor has the potential to really maximize losses: they will be fully exposed to political risks or events like Dutch disease (when a commodity-led boom leads to currency appreciation, thereby suffocating the local manufacturing industry). If you are fortunate enough to choose a country experiencing such changes, you will no doubt be successful in your goal to achieve miserable investment performance.

2. Confuse cost with quality.

The goal of earning poor returns will be greatly advanced by confusing cost with quality. First, pursue strategies that will leave your clients exposed to absolute risk (the permanent impairment of capital). Choose strategies that fail to safeguard clients against investment bubbles, such as an index fund. The negative impact could be exponentially higher than the fees saved. Shun active managers that are actually able to mitigate the risk of the madness of crowds due to a disciplined investment approach. Do not engage in more niche active management strategies, where the fees are consistently a fraction of the alpha potential (e.g., some small cap strategies).

If choosing an active manager, make sure their strategy is based on their own subjective reality. It should involve the ability to predict obscure, utterly random events, like calling for a coin to come up heads five times in a row. This will be sure to send you down a path to disappointment when their luck runs out.

Such an intuitive method should be obscure and inconsistent. You certainly shouldn't be able to understand the manager's investment strategy. If it truly is based on a subjective reality, it shouldn't make any sense when questioned objectively.

Earning poor returns requires paying as much in fees as possible for investment management services. Utilize layer upon layer of professional services, who themselves incur multiple layers of fees. Paying for active asset allocation and hiring a fund-of-funds manager to select active managers is a good start. Also, hope the active managers invest in hedge funds or closed-end funds that charge an additional fee. As an ancient Greek plebeian once said, “it sure does cost a lot to be wealthy – I don't see how anyone can afford it”.

Do not forget to set the environment with poorly conceived incentives. The incentives for investment managers should skew risk and reward negatively for clients. A must is the 2/20 compensation model, which provides investment managers with a base compensation of 2% but allows them to share 20% of the profits after reaching a target that they set. This encourages managers to assume excessive risk. If the risk leads to reward

they maximize their fees, if not, it was never their capital at risk to begin with. When the market turns sour, client returns are more severely impaired as a result. Optimally, the investment manager should not have an ownership stake to align their interests as they may not share the goal of poor risk-adjusted performance. As well, be sure the investment manager can trade stocks in their personal account, so that their attention is directed elsewhere.

3. Destroy wealth.

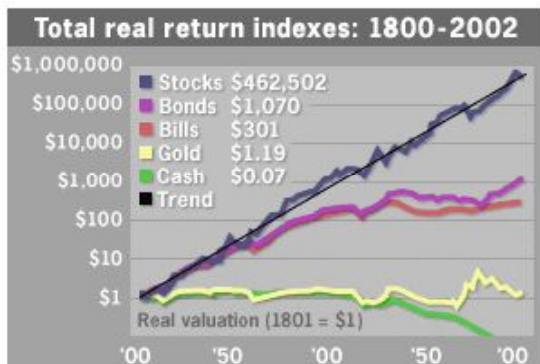
Select manager styles that substitute losing strategies for winning strategies. Investment returns can be permanently impaired when managers invest in securities that don't make money, significantly expediting our goal of dismal performance. Despite the advancement of capitalism, there are plenty of opportunities to invest in losing games. Some of these include:

Junior exploration stocks – This category includes businesses with no producing properties but plenty of prospects. It is best that the company is burning cash and although there is blue-sky potential, the actual probability of success is remote. These companies are notorious for raising equity, diluting investor interests. There is no need for managers to focus on valuation when the intuitive method can be used to evaluate these stocks.

Invention or concept stocks – These are usually accompanied by a slick video presentation and product samples, but place less emphasis on financial statements. The goal is aided most when there is no business model to tie the story back to reality.

Zero discount rate investments – These include investments in assets that don't produce a stream of cashflow for investors and have to be "wished" higher to make money. The all-time favourite no-discount rate investment is gold, which has a cost of carry – you have to pay someone to store it for you.

Exhibit 1: Stock returns vs. Gold²



2 Source: Jeremy Siegel's Stocks for the Long Run

Companies that make money but destroy wealth also contribute to poor investment returns. Nothing is more delightful than a business that allocates capital to projects expected to earn 5% when its cost of capital is 10%. Company managers that have egos and enjoy empire-building (i.e., making acquisitions at ridiculous prices) increase the probability that wealth can be destroyed, which moves us closer to our goal.

4. Invest emotionally.

One of the most significant ways an investor can ensure investment death is to accentuate all that is human when making investment decisions. Emotions, mental short cuts and overconfidence will guarantee your portfolio is the worst it can be.

Invest only when you feel completely at ease with the stock market; this will ensure you maximize your opportunity to buy high and sell low. Do not take advantage of the extreme fear and hubris that pushes investors to buy or sell at any price. In fact, to achieve the worst possible portfolio, follow their lead! Warren Buffett suggests being "fearful when others are greedy and greedy when others are fearful"³. This must be avoided if investors want to overpay for securities purchased and receive as little as possible for securities sold.

The human brain feeds on positive reinforcement, which is why a bull market reinforces our notion that it is an ever-better time to invest. Conversely, when prices are falling, it is perceived as a worse time to invest. The human brain happily ignores the logic that lower prices mean better value, all things being equal. So, fortunately for those attempting to experience investment death, investing emotionally comes with very little effort at all.

The brain uses heuristics (mental short cuts) to simplify complex decisions. This tendency will move us closer to the goal of investment death. One example is equating action with effort. A high turnover portfolio has a great deal of activity, which an investor in search of poor returns should equate to a lot of effort. The portfolio also has higher costs. If commissions and taxes are a win for brokerage firms and governments, the pie must be getting smaller for clients. Fortunately, the majority of investors suffer from an overconfidence bias, leading to significant portfolio churn in the industry and greater transaction costs for investors.

Human factors and over-confidence contribute to investment bubbles like the recent housing bubble, the Tech bubble, the Japanese bubble, the Florida Land Boom, the Dutch Tulip Craze and the South Sea bubble. Bubbles are a great way to lose money in the market. Investors should be guided by their emotions and, in the face of overwhelming logic, should concoct

3 Warren Buffett's 2004 Letter to Shareholders

elaborate stories to justify exorbitant valuations (e.g., brick and mortar businesses will disappear because of the Internet). You may need to temporarily suspend your understanding of reality when prices rise without reason. If you do realize that you are investing in a bubble, try to time it. Playing chicken with a financial bubble is an efficient way to ensure poor returns. Maximum focus on short-term returns and relative positioning compared to a benchmark will strengthen this effect.

Conclusion

If you can restrict yourself to the smallest investment universe possible, confuse cost with quality, destroy wealth and invest emotionally, you will be well on your way to achieving dismal investment returns.

Lastly, for miserable returns and a miserable life:

“Learn nothing vicariously through others and the lessons history has to teach.” (Charlie Munger)

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