Our Equity Investment Philosophy

Executive Summary

- An investment philosophy is a set of guiding principles that inform and shape an individual's investment decision-making process. It should reflect a coherent way of thinking about markets, how they work, and the types of mistakes that consistently underlie investor behavior.
- We believe that equity markets are inefficient. Extensive empirical evidence demonstrates that excess returns can be earned through disciplined investment strategies.
- There are two main reasons for the persistence of market inefficiencies: investors' biases and the institutional model followed by large investment firms.
- According to Behavioral Finance, most people tend to make decisions based on emotions rather than logic or rationality. Such biases affect both individual and professional investors.
- An active manager can only add value by deviating from his benchmark index. However, the evidence shows that managers, on average, build portfolios not significantly different from their benchmarks due to institutional factors that encourage them to over-diversify.
- We believe that investors' behavioral biases and the dominance of large institutions are permanent, structural phenomena that can be exploited to earn excess returns over the long term.
- Our investment principals are built upon the concepts of empirical research, disciplined process, risk management and transparency.

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Investment Philosophy

An accepted definition of investment philosophy is “a set of guiding principles that inform and shape an individual's investment decision-making process”.

A more insightful and relevant definition is “an investment philosophy is a coherent way of thinking about markets, how they work, and the types of mistakes that you believe consistently underlie investor behavior.”[1]

This definition implies that investors’ behavior and their aggregate actions determine market fluctuations . More importantly, if investor behavior is biased and somewhat predictable then there is an opportunity to exploit such recurring mistakes to earn excess returns. This belief is in contrast with the Efficient Market Hypothesis (EMH) – a cornerstone of modern financial theory that states it is impossible to "beat the market" because share prices always incorporate and reflect all relevant information. According to the EMH, stocks always trade at their fair value, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices. As such, it should be impossible to outperform the overall market, and that the only way an investor can possibly obtain higher returns is by purchasing riskier investments.

We disagree with such a theory and believe that equity markets are inefficient. Extensive empirical evidence demonstrates that excess returns can be earned through disciplined and systematic investment strategies. For example a number of papers have documented the value effect – excess returns to buying stocks with low valuation multiples such P/E, P/B or P/CF. There is also extensive evidence on price momentum – excess return to buying stocks which have strongly appreciated. Another well documented inefficiency is the “accruals anomaly” - stocks with positive (negative) accruals significantly under(out)-perform the market.[5]

How do we explain the presence and persistence of these excess returns in a market supposed to be fully efficient and rational? We believe there are two main reasons: investors’ biases and the institutional model followed by large investment firms.

Let’s start with investors’ biases. Over the last two decades a new field of finance has developed – Behavioral Investing. According to this view, most individuals tend to make decisions based on emotions rather than logic or rationality. This is particularly true when the problem is complex and when information is incomplete, ambiguous, shifting, or competing; when stress is high and when decisions rely upon interaction with others.[2] These are often the circumstances surrounding investment decisions.

This emotional bias manifests itself in several ways such as over-reaction to market events, over-optimism, overconfidence and confirmatory bias.[3] Such biases ultimately result in investors’ making costly mistakes. For example the Dalbar study shows that mutual fund investors have significantly underperformed the S&P 500 over the past 3, 5, 10 and 20 years. The average stock fund investors lagged the index by nearly 4 percentage points per year from 1993 to 2012. Dalbar found that more than half of the gap in returns can be attributed to performance chasing and other bad investing habits. The lesson is that “Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who hold on to their investment are more successful than those who time the market.”[4]

Ultimately investors’ biases and resulting mistakes origin from how our brain works. The emotional side (X-system) tends to dominate the logical side (C-system), even in investment decisions. It is important to highlight the fact that these limits to rational decision-making affect institutional (professional) and individual investors alike.

[1] Aswath Damodaran, “Investment Philosophies”, John Wiley & Sons, Inc., 2012; [2] Gary Klein, “Sources of Power: How People Make Decisions”, MIT Press, 1999; [3] See for example, James Montier, “Behavioural Investing, A Practitioners Guide to Applying Behavioral Finance”, Wiley Finance, 2007; [4] Dalbar, Quantitative Analysis of Investor Behavior, 2013; [5] For a comprehensive review of market anomalies, see Leonard Zach, The Handbook of Equity Market Anomalies, Wiley Finance, 2011.

Let's now turn our attention to the other driver of market inefficiencies: the institutional investment firm's business model.

A number of academics and practitioners have analyzed the performance of mutual fund managers over long periods and found that on average fund managers underperform the market quite consistently.[5] What is the cause of such persistent underperformance? It is obvious that an active manager can only add value by deviating from his benchmark index. However, the evidence shows that managers, on average, build portfolios not significantly different from their benchmarks.[6] Thus, managers' poor performance is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to over-diversify: a) The style box system widely employed by investment consultants and pension funds limits managers' opportunity set by forcing them to select stocks from a narrow sub-set; b) Quarterly performance reviews against peers and benchmark results in managers focusing on short-term performance and herding.[6]

As an investment management firm grows, its focus shifts from investment performance (risk) to business performance (risk). At the beginning, investment performance is very important to attract investors, but as the assets under management grow, economies of scale result in increasing profitability. This favorable business dynamic results in an emphasis on mitigating the risk of losing mandates. This is accomplished by minimizing tracking error (i.e., managing a portfolio to closely follow the index to which it is benchmarked).

There is also evidence that institutions on aggregate show little tendency to bet on any of the main characteristics known to predict stock returns, such as book-to-market, momentum, or accruals.[7]

We believe that investors' behavioral biases and the dominance of the institutional model are not transitory phenomena but structural in nature. Their pervasive character offers aware and unconstrained investors the opportunity to earn excess returns over the long term.

Our Investment Tenets
The empirical evidence on rule-based strategies and their explanation based on the predictable behavioral bias of individual and institutional investors shape-up our investment philosophy.

1. **Equity Markets Are Inefficient**: markets are far from being efficient as they do not fully reflect all available information.

2. **Empirical Evidence**: investment decisions and portfolio management rules should be based on empirical analysis of fundamental data over extensive periods and varying market conditions.

3. **Process is Key**: a rule-based portfolio management process mitigates behavioral biases and contributes to long-term performance.

4. **Transparency**: Our beliefs and research process are clearly and consistently reflected in portfolio structure. Investment decisions are driven by the systematic application of buy and sell rules.

5. **Risk is Permanent Loss of Capital not Tracking Error**: Our strategies are designed to maintain consistent exposure to predictive fundamental factors - not to belong to a specific "style box." Strict adherence to benchmarking while reduces tracking error, limits managers' ability to exploit market inefficiencies and can paradoxically increase portfolio risk.

[5] For example see: Wermers, Russ, 2000, Mutual fund performance: An empirical decomposition into stock-picking, talent, style, transactions costs, and expenses, *Journal of Finance* 55, 1655-1695; The annual S&P Indices Versus Active report by S&P Dow Jones Indices is an annual comprehensive study on mutual funds performance by style, available on www.us.spindices.com. [6] Dasgupta A., Prat A., Verardo M., 2011, Institutional Trade Persistence and Long-Term Equity Returns, The Journal of Finance, VOL. LXVI, NO. 2.
[7] For example see: Antti, Petajisto, 2013, Active share and mutual fund performance, available on www.ssrn.com.; Lewellen, Jonathan, 2011, Institutional investors and the limits of arbitrage, Journal of Financial Economics.

Portfolio Management Massimo Santicchia is a Co-Founder and Chief Investment Officer of Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages quantitative equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of the JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.

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