Creating Winning Conditions in the Stock Market with an Investment Professional

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People often wonder why most institutional investors don't beat their benchmark. Of course, there is high management fees, often from 2% to 3% annually for stock mutual funds, or lofty performance fees for hedge funds; these make it difficult to beat an appropriate index over a significant period, notably a full market cycle (say 10 years). But there is more.

Part of the answer lies, in my opinion, in understanding the conditions under which institutional investors work (portfolio managers, mutual funds, hedge funds or pension funds managers).

Agency risks associated with funds management

The key to success in investing is the ability to be patient and to strike only when the odds are clearly in our favor. You step at the plate and you have the option to let hundreds of tough pitches pass by. You wait until the pitcher is tired or distracted and throws a fat and easy pitch; it is at this moment that one must strike decisively for a safe hit (1).

Professional investors do not always have the option to be very patient because they are accountable to their bosses or their clients, often having to report at fixed intervals, somewhat artificial moments that have nothing to do with investment opportunities and risks. They must deal with their bosses' or clients' own patience and perceptions. Many professionals succeed in managing this relationship, but it still has the potential to create distortions, sometimes called agency risks.

Here are some generally recognized examples of disadvantages or biases of professional managers (2):

- Career risk: there is a tendency for some professionals to follow the heard and invest like their peers. In terms of career risks, it is better to fall at the same time as everyone else when there is a crisis or a crash, rather than stick one's neak out with an original idea, or go against the flow, thus risking being singled out with a bad bet. This increases the chances of losing one's job or clients. There is a ratio "Career Risk / Higher Probability of Return" which favors staying more conservative, mimicking others, or hugging an index i.e., not straying too far from the securities that make up one's benchmark;

- Management of a common stock fund: often, when there is a steep correction in the stock market and opportunities arise to buy at a discount, clients panic and withdraw money, forcing the fund manager to sell stocks to create liquidity when she should be buying, which is detrimental to the fund manager's performance;

- Tendency to keep up appearances; for example, make transactions that look good in a

end-of-month report, like buying popular stocks whose price has already gone up a lot, or selling a stock which has fallen sharply, regardless of future potential; this practice is often called “window dressing”;

- Excessive optimism and overconfidence: many professionals do not convey clearly enough that investing is basically predicting the future and should be viewed in terms of probabilities and averages, not overconfident forecasts;

- Natural propensity to want to increase the size of assets under management: beyond a certain point, the more a fund grows, the more difficult it is to perform well, because more limited are high potential investment options large enough to move the needle. Hence, some of the best managers close their funds to new clients to limit their size.

Finding inspiration from the Buffett Partnership’s Ground Rules

Institutional investors provide an important and useful service, but one must be aware of the risks inherent with financial intermediaries and take steps to reduce them. This requires from the professional thorough and transparent communication with her clients. In the case of private portfolio management, it is necessary, in my view, that there be a clear initial understanding with clients about the management philosophy, and conditions and measures of success. Warren Buffett, in his early years at the helm of the Buffett Partnership (1956-1969), handed out to his clients his seven "Ground Rules" (3), which outlined his investment philosophy and how he wanted to be judged. I highly recommend the reader consult these seven rules.

Investment professionals should establish their own ground rules. For example, at Préfontaine Capital, we agree with our clients on the fundamental need to invest as long-term owners in businesses, and to avoid playing the stock market in a futile effort to try to predict its short-term movements. *We mitigate the career risk/window dressing/overconfidence biases by being invested ourselves in the same stocks as our clients*. We stress the fact that the amount of transactions does not reflect the amount of work done for a client and that certain stocks may compound for many years in a portfolio. It's the quality of judgment and not the amount of activity that will drive long term positive results. Clients must also accept that there will be periods when our investment style will be out of favor, especially during stock market euphoria, during which we will underperform. Clients should expect that certain stock purchases may appear counterintuitive or even uncomfortable; also accept that we will not be able and will not try to predict recessions, political crises or stock market crashes, but that we will focus on the quality of companies in which we invest. We also agree with clients on their goals, how to reach them, and how to evaluate the success of the portfolio and the work of the manager, so that we can afford to be patient when investing.

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(1) On this subject of patience, I recommend reading Professor William N. Thorndike's book: *The Outsiders*, Harvard Business Review Press, 2012, which describes the remarkable career of eight CEOs and how their great patience has led to extraordinary returns over long periods.
(2) On biases, see *Financial Behavior: Players, Services, Products, and Markets*, H. Kent Baker, Greg Filbeck, and Victor Ricciardi, Oxford University Press, 2017.
(3) Warren Buffet’s Ground Rules, Jeremy C. Miller, Harper Collins, 2016