People's United Advisors

INVESTING

A Wonderful Life

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Looking back now, the spring of 1982 was a great time to be a newly-minted college graduate. Armed with a degree in finance and a burning desire to build a great business, I was full of confidence, as were each of my classmates. Unfortunately, as many remember, the economic environment of the early '80s was stuck in the Carter "malaise" and had not yet transitioned to Reagan's "morning in America."

It is at this point in my narrative where I should falsely claim a prescient knowledge that the stock market, represented by the Dow Jones Industrial Average, would bottom just three months after my graduation and begin an advance in magnitude and duration of unprecedented proportions. *Figure 1 (next page)* illustrates the 16-year stagnation, from the late '60s to the early '80s, followed by the current 39-year boom, interrupted only infrequently. To have chosen a career in finance, on the eve of the greatest market expansion in history, was truly a blessing for which I can claim little credit but for which I will forever be grateful. In life, it is often more productive to prove yourself worthy of the opportunity that fate has bestowed on you rather than waste time questioning your good fortune.

Over the ensuing years since 1982 there were wars, market crashes, and a global pandemic. Hanging chads, fake news and impeachment became normal in Washington, while booms and busts defined Wall Street. Through it all, the strength of the U.S. economy and the resilience of our people supported growing prosperity and a rising stock market.

As investors, we know there were lessons to be learned and "truisms" to be challenged. As a student and practitioner of investing, I've had the chance to learn from both from my own experiences and many great investors. I would like to share some lessons I've learned that have served me well. I believe that they're timeless, but we'll really know only when I, or another writer, reprises this note at a date far in the future.

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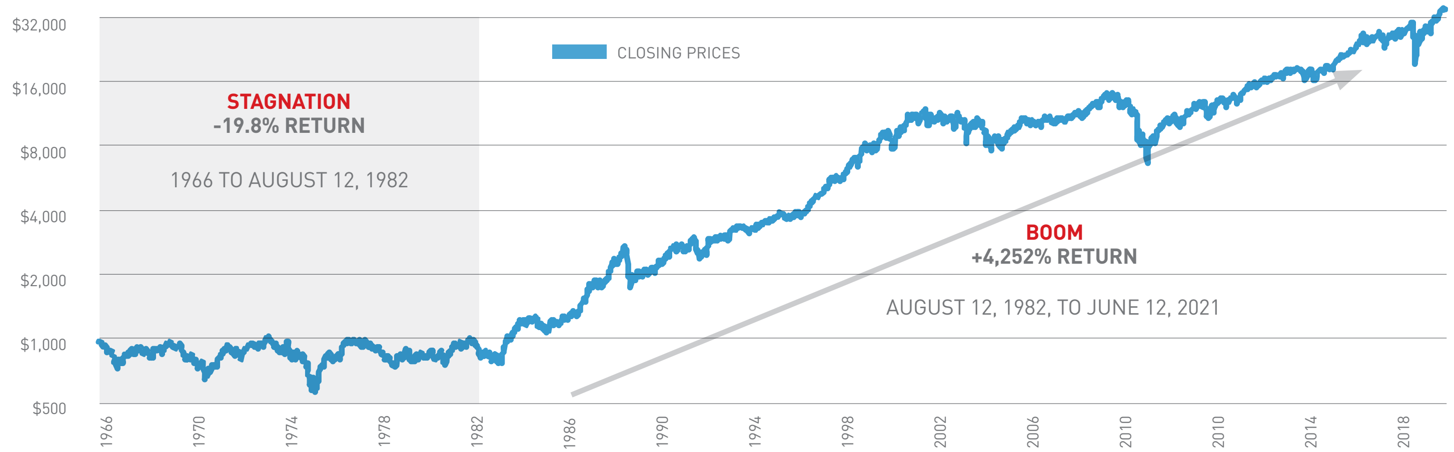
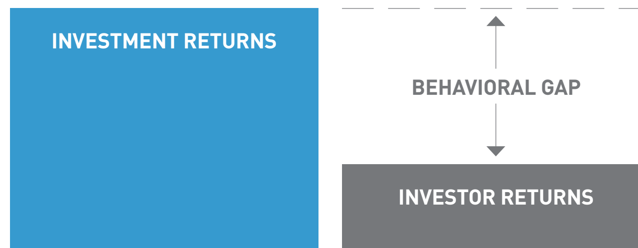
FIGURE 1: U.S. STOCKS: A DECADE AND A HALF OF INERTIA FOLLOWED BY A FOUR-DECADE EXPANSION
GROWTH OF $1,000 IN THE DOW JONES INDUSTRIAL AVERAGE (USING CLOSING PRICES)



Source: Bloomberg L.P.

FIGURE 2: THE BEHAVIORAL EDGE®



Source: Fuller & Thaler Asset Management

Lessons from the Boom

1. Investors are normal, not rational.

Having lived through many wild market swings and watched many prominent investors make decisions based on emotions, I learned to question the prevailing academic construct that investors are cool, rational beings. Rather, I have found investors to be normal, which means they're subject to biases and emotions when making decisions. All too often investors chase performance, whether it's a high-profile stock or a hot mutual fund. Most investors buy too late and suffer through the eventual decline. *Figure 2*, provided by one of the firms we work with, perfectly illustrates the opportunity cost that many investors pay as they buy high and sell low: The return gap can be considerable.

2. Price is what you pay; value is what you get.

There is much discussion in the financial press about valuation levels in the markets without actually defining "value." While each investor may have a different estimate of the value of a specific asset, the process of determining that value is the same.

The present value of an asset is the sum of its future cash flows discounted back to today. A perfect example of this concept is a zero-coupon bond: a bond purchased at a deep discount today that pays its face value at maturity. If you know the maturity value, the interest rate, and the time to maturity, calculating the bond's value is simple arithmetic. When valuing equities, however, the cash flows and discount rates are unknown, requiring investors to make their own estimates. Without going into all the nuances of valuing discounted cash flows, I'll simply say that valuation is always a process designed to assess the cash flows an asset generates and then discount those flows back to today.

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The *price* of an asset is set in the market by buyers and sellers who are subject to the pull of emotion, both positive and negative, as they settle on a market price. But it can diverge widely from *value*—what you get from the asset. For example, think back to the dot-com stocks at the turn of the century. Many of the companies had no hope of ever generating sufficient cash flow to justify their prices, but enthusiastic investors sent the prices skyward—until reality set in and prices plummeted. A thoughtful investor keeps a clear-eyed forecast of an asset's value in focus and buys when the price falls below that value by a sufficient margin.

3. Challenge the prevailing wisdom.

In order to outperform the market, you must think differently than the market. The prevailing wisdom of investors, captured by current market prices, reflects the sum of positive and negative news about the asset. I am always bemused when I hear an analyst on television say they own a particular company because it has been a great company for years. We all know it has been a great company, but I'm investing for the future, not the past.

The question every investor must ask prior to making an investment has three components: *(1) What is current market thesis, or outlook for the company? (2) Do you have any alternative view, or antithesis, for the outlook? (3) What is the catalyst, or synthesis, that will bring investors around to your view of the company?* The Philosophy majors reading the foregoing will recognize these three points as a Hegelian dialectic. The key take-away is that if you want to outperform you must challenge the prevailing wisdom that's reflected in a stock price.

4. Volatility is not risk.

The academic definition of risk is volatility. Measuring volatility may help simplify some complex calculations, but they don't capture how most investors view risk. Academics tell us that large upward and downward price movements are equally bad. But most investors I know like the upward price moves. It's when stocks decline that they get nervous and want to sell. And so, investors have a very asymmetric view of risk when it comes to volatility. Researchers have found that investors feel the pain of a loss twice as strongly as the elation from a gain: It takes a gain of $20 to equal the pain of a loss of $10.

If volatility is not a useful definition of risk for investors, what is? I have found that for most investors, risk is the chance that their long-term goals won't be achieved: They don't retire when they want to, or they don't have the funds to put their children through college. Risk is therefore the permanent loss of capital so that goals aren't achieved. This definition makes risk a more personal factor rather than a single number. The decline in the price of an asset could be a non-event for one investor and catastrophe for another.

It is striking to watch professionals in the investment business who expend great amounts of effort trying to distill risk down to a single number. John Maynard Keynes, one of the founders of modern economics, was also dismissive of those who put too much faith in quantitative data. He said, "When statistics do not seem to make sense, I find it is generally wiser to prefer sense to statistics."

5. Don't pay alpha prices for beta returns.

There are two terms used to describe the returns that managers achieve for their clients. "Beta" is the return of market indexes such as the S&P 500 for large U.S. stocks or the Russell 2000 for small stocks. With the advantage of index funds and ETFs that can capture the return of indexes very cost-effectively, investors can now get beta return very cheaply.

"Alpha" is the return a manager earns above the index, which is highly sought after and deserves a higher fee. If a manager charges an alpha-appropriate fee for a mutual fund or individual account that's just earning market returns, that manager will probably see his or her assets moving to lower-cost options. The ability for investors of all sizes to clearly understand the value that a manager is creating and then to decide whether the fee charged is justified has improved the investment-management industry.

Know Thyself

As I offer this short reprise of a life, and a career, filled with good fortune, I find that one unifying principle neatly knits together the five lessons I've learned. The "golden rule" that captures the essence of those five lessons actually dates to ancient Greece and the Temple at Delphi. Inscribed in stone above the entryway is the phrase "Know Thyself." I believe that the greatest asset I possess, along with the greatest liability, is me. Understanding my biases, strengths, and weaknesses and then building a framework to profit from those traits has been the greatest lesson I have taken away from the last 39 years. I cannot wait to see what I learn over the next 39!

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