PORTFOLIO NOTES & INSIGHTS

The Humans Behind the Rules

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A simple mechanism, the rule, has freed up unbelievable human capacity. The technology that advances around us every day nearly all comes back to this simple premise: that you can put instructions, or rules, in place to automate previously manual tasks. If situation A occurs, do action 1. If situation B occurs, do action 2. Such a basic approach has expanded to the point that rules-based technology is part of every industry, including money management.

The more complex the rule system and/or the larger the set of data inputs, the greater the advantage of using a computer to make decisions. In the investment world, computers are what enable us to find performance patterns or to screen securities for particular characteristics, as they process large quantities of data and free investment analysts from untold hours of number crunching just to create the data. Computers have even enabled us to better understand investor behavior—to know how investors are likely to react in certain situations and what features investors reward with higher prices.

It's easy to disconnect these tools and applications of technology from the humans who made them. But, we must always remember that rule-creation is a human activity. The rules come from us.

Sometimes, rules-based technology fails—either because the rules were wrong, or because a situation arises that never arose before. In investing, we're lucky that the consequences are not nearly as dire as in other circumstances, but we are still keenly aware that the technology at our fingertips ultimately relies on the set of rules or instructions programmed into the computer to be effective.

Therein lies the rub. No set of rules or instructions will ever be a perfectly complete or sufficient set for investment decision making unless we can be assured that the set of rules covers all possible cases in all possible circumstances.

Is that even possible, in investing? Investors must always ask whether the past patterns and relationships that underpin the rules apply today will apply tomorrow. Investors who fail to ask are effectively committed to the belief that the future faithfully replicates the past. Markets often follow patterns from the past, but they can diverge from past patterns and occasionally do so in a persistent manner and can do something brand new, something never seen exactly that way before.

A simple example is value investing. A statistical analysis of historic returns shows that value stocks have outperformed growth stocks over the long term. A rule for successful investing, therefore, would be to overweight value stocks in your portfolio. However, if you had followed this rule since 2012, your portfolio would have lagged as growth stocks outperformed value stocks by more than 20%.

Ultimately, then, a rules-based investment program needs to have flexible rules. It needs to be able to recognize and capture the sustained periods when the standard rules do not apply.

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Since these periods are, by definition, anomalies, detecting them usually requires a deep knowledge and experience of the markets. It is where expert analysis can supplement quantitative research and make a real difference for investors. And for all the technology around us, there's only one source that can provide this kind of activity: humans.

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