MONOGRAM

NEWSLETTER: 'Man vs. Machine' — May 2017

Performance.

The Fund returned 0.8% in April, bringing the year-to-date return to +4.8%. The month saw a revival in performance of risk assets largely due to a more predictable political environment emerging in Western Europe with the French elections: Global Equity (ACWI) rose +1.6%, Developed ex-US Equity (EAFE) was up +2.4% and US Equity (S&P) up +0.8%, US Investment Grade Bonds and High Yield Debt gained approximately +0.5% while Gold was down -1.8%.

Why we believe in Rule-Driven Investing.

The overwhelming and indeed frequently published evidence that active funds across all asset classes are the poorly performing cousins of their passive rivals should come as no surprise given the large number of clever researchers doing their earnest best to ensure market efficiency[1]. Furthermore, the gold standard investment management qualification, the CFA, is now held by around 180,000 professionals around the world, compared with a mere 284 in 1963. Quite simply, the poor stocks have no chance – they are being researched to death!

In parallel, whereas in 1963 80% of funds were not professionally managed, today c. 70% are so managed! A more convincing series of numbers to explain the increasing efficiency of markets would be hard to find.

If in addition we consider the difficulty of forecasting economic and financial variables as key components of any 'active' investment strategy, then the arguments against active investing reign supreme.

Of course, economic narrative is always fascinating but in reality, offers little consistent insight into successful investment recommendations.

The recent rapid growth of passive investing inflows is, of course, the ultimate manifestation of this ultra-efficiency, with investors increasingly aware of the scientific evidence on the futility of active management and economic forecasting. We certainly subscribe to the above passive investing philosophy while acknowledging that certain 'smart beta' strategies can lead to outperformance relative to conventional market cap weighted benchmarks. For example, 'momentum' investing (picking a portfolio of the best performing stocks over the last year, say the top 20%) has a sound track record. Though this should not be seen as a reward for successful market-timing, rather it is a reward for exposure to 'style' risk premia. As charges for smart beta ETFs have been falling dramatically of late, these strategies are becoming increasingly viable.

Of course, 'smart beta' strategies are examples of 'rule-based' investing, whereby a manager/computer follows a set of rules, which have been extensively tested over different markets and historical periods and, once the rules have been agreed upon, there is no further human intervention or discretion. This latter point is very important since decades of study of behavioural finance and related psychological research have told us that far from being rational, optimising computing geniuses, humans are merely mortal investors, full of biases and inconsistencies.

If we combine the impossibility of consistent, accurate economic forecasting (see Andy Haldane's speech recently[2]), the time-varying and unpredictable relationship between economics and capital market returns, along with the frailty of human decision-making, it is no surprise that active fund management, while obviously a zero-sum game, is also fraught with a lack of consistency.

Even an FT Money writer recently suggested[3] that 'Simple rules work' with regards to stock selection – e.g. momentum investing, trend-following and seasonality themes such as 'sell in May'.

There is a distinguished literature outside of asset allocation and investment analysis, which promotes the idea that systemic rules beat discretion in decision making. Work associated with Paul Meehl

[1] Ref. FT article: "87% of active UK equity funds underperformed in 2016", 2nd April 2017. Link: www.ft.com/content/3fceed90-13ae-11e7-b0c1-37e417ee6c76?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-92.

[2] Ref. FT article by Chris Giles, 6th January 2017: www.ft.com/content/e94c96a2-d3e3-11e6-b06b-680c49b4b4c0

[3] Chris Dillow, FT Money, 13th May 2017, p.10

back in 1954[4], and Robyn Dawes in 1979[5], amongst many others, showed that even very ‘rough’, ’approximate’ statistical models are often better than expert opinion. Many of their experiments involve education, sociology, medicine and indeed aspects of finance.

Undeniably, in this literature imprecise, ’rough’ portfolio construction models (such as ‘unit weight’, otherwise known as equal weight) are shown to offer surprisingly good results relative to experts. What is more, one does NOT need a sophisticated optimising model to outperform experts! This is because the inputs (e.g. expected returns) going into such models, while intended to create optimised portfolios, are so wildly inaccurate as to be worse than useless. But this has been well known in the context of investing since Michaud’s paper[6] in 1989. Despite this, the discretionary investment industry continues to survive in reasonably good shape.

All historical periods are highly uncertain, with little chance of sophisticated ex ante probability analysis offering anything useful beyond Fool’s Gold. Hence, we believe that it is best to filter out the noise, place discretion to one-side and allow a simple, systematic approach to provide investment guidance. There is a huge body of research across many disciplines, which supports this viewpoint, though perhaps surprisingly it has attracted little interest from investment managers – after all, it would suggest that much of their effort is redundant if not misleading. To quote Paul Meehl, an eminent scholar in the field of systematic vs. discretionary decision-making:

> “…there is no controversy in social science that shows such a large body of quantitatively diverse studies coming out so uniformly in the same direction as this one [models outperform experts]“.

To this end the MONOGRAM systematic approach to investing is well supported by a growing recognition that rules beat experts.

The rules we use to choose our investments are based on a wide range of scholarly research as well as rigorous in-house testing across many asset classes and historical periods: if one cannot see the future then it is only through exhaustive, objective analysis of the past that one can hope to find patterns of behaviour which can be exploited for investment success – and that is exactly what our rules-based approach seeks to achieve.

Positioning and outlook.

For the month of May our indicators continue to favour US and Developed ex-US Equity, US High Yield and US Investment Grade Bonds. Gold has swung out of favour and we no longer hold it.

As always, we will be watching closely and respond accordingly as events unfold.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms. There are two options for investors to access MONOGRAM’s investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM’s bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are available on request.

For further information on MONOGRAM or to invest, please contact Milena Ivanova on **+44 (0)7931 776206** or **milena.ivanova@monograminvest.com**.

[4] Ref. ‘Clinical versus Statistical Prediction’ 1954 by P. E. Meehl

[5] Ref. ‘The Robust Beauty of Improper Linear Models in Decision Making’ 1979 by Robyn M. Dawes, University of Oregon

[6] Ref: “The Markowitz Optimization Enigma: Is Optimized Optimal?” 1989 by Richard O. Michaud, Financial Analyst Journal