VALUE ARCHITECTS
ASSET MANAGEMENT

The Dangers in Automated Investing

Recently, one of our friends brought a preliminary prospectus to our attention which outlined in great detail four pages of security selection criteria and a sophisticated ranking methodology that selected a final portfolio through several iterations using what is known as multiple regression technique. Has investing become a purely quantitatively driven pursuit? Is automated investing the future?

We think that there is more to investing than a pure numbers driven statistical exercise in our opinion.

"Numbers" people believe that valuations should be strictly about numbers and that narratives/stories are distractions that are often irrational. "Narratives" people believe that valuation and investing is really about great stories and that it is the height of hubris to depend too much on eggheads' numbers when you face uncertainty. Trekkies will remember the conflict between Dr. Leonard McCoy, the passionate, highly emotional chief medical officer on the USS Enterprise and his arguments with Spock, the half-human, half Vulcan science officer who suppressed his emotions and let logic drive his decisions. Similar conflicts exist today among fundamentally driven investment managers and behaviorally driven investment managers.

Even the Nobel Prize committee for the 2013 found itself conflicted as it awarded the prize in economics to Eugene Fama who demonstrated that stock prices were difficult to predict in the long term and was a father of the Capital Asset Pricing Model (CAPM) that led to the emergence of index funds. It also awarded a prize to Robert Shiller whose work contradicted many CAPM beliefs and suggested some predictability in long term values.

To number crunchers, accounting earnings are viewed as measures of economic earnings. Though Wall Street tends to bow and scrape at quarterly earnings releases and their "surprise" element as if earnings represented gospel, the reality is that every calculation of profit reflects choices among competing theories of accounting. None of these necessarily reflects the simple truth. They depend on inherently imprecise ideas such as fairness, reasonableness, being appropriate under the circumstances, and assumptions. Our own belief structure is based on "Profit is an opinion; cash is a fact." Hence, the complexity of GAAP and the broad set of choices often makes pure reliance on the "numbers" unreliable!

The economist John Maynard Keynes once said, "Nothing is more suicidal than a rational investment policy in an irrational world." Decision-making by investors seems to be least effective when information exists in extremes, whether there is either too little or too much. Back in the early 1980's, the Wall Street Journal did an autopsy of oil-price forecasting that had completely missed the downturn in oil prices and had mistakenly projected ever higher oil prices. As the article stated, "Forecasters, faced with so much uncertainty, have clustered together like a herd of sheep." Piling data on top of data tends not to increase the quality of decision-making, only the certainty of conviction, thus adding a false sense of security. More recent datapoints show that human nature, or statistical processing has not improved.

The collapse of the firm Long-Term Capital Management jeopardized the financial system in 1998. The company used complex mathematical models to take advantage of arbitrage deals. Among LTCM's principals were several former university professors, including two Nobel Prize-winning economists. Even just this year, the overwhelming majority of economists were in hearty agreement but absolutely wrong as they projected higher interest rates for long term bonds. Instead, the bond market has rallied through most of the year.

Mark Twain once said, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Too much reliance on formulas, on statistical measures, and on data-mining ultimately convinces folks of the certainty of their projections. There is an illusion of precision when you rely strictly on numbers. We wonder if this illusion is actually a delusion. The greatest success in investing is made when events occur that are not broadly foreseen. It's been said that 99% of investing has occurred within two standard deviations but everything truly exciting has occurred in that 1%.

Obviously, none of us are able to invest with a perfect score. Superior investors are superior because they have a better appreciation of the range of potential outcomes and their probabilities. Warren Buffett, for example, has no spreadsheets and uses a computer primarily for online bridge. Thinking and having an opinion goes beyond regurgitating facts. When it comes to analyzing and selecting stocks, the superior analyst's activity should not consist of simply looking at hundreds of ratios. The understanding comes from looking behind those numbers. One constantly seeks answers, looks for competitive advantages and asks why.

For us, investing requires experience that extends beyond number crunching. We like the discipline of number crunching, but recognize the limitations of total reliance on it. We need numbers as a measurement mechanism or a feedback loop to verify how a business is doing. Reasonable assumptions can be stymied by the uncertainty of future events.

Being successful in investing does require an understanding of asset prices but that understanding comes not only from fundamentals and analysis, but from an appreciation of risk, risk attitudes and behavioral finance.

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