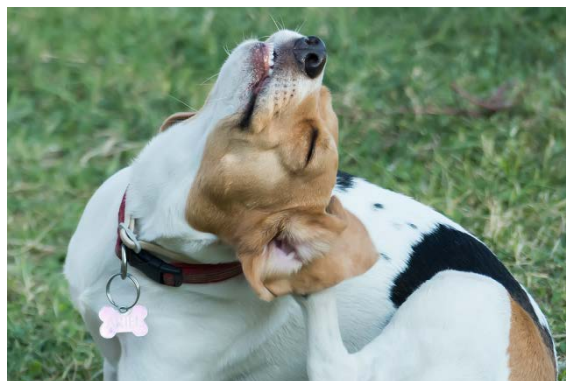


Career Risk, Alpha, and Contrarian Investing

At our firm, one of our main goals is, very simply, to generate excess returns from equity investing without taking commensurate risks. When we take a step back and think about it, another way of stating this is to say this: over time, we hope to generate returns that are comfortably above the returns our investors should be able to capture themselves without much work, and demonstrably above the average returns of our peers in the same business. In order to achieve these excess returns, we not only need to be right, we need to be willing to be wrong. The latter is an unnatural skill, and requires a conscious effort to develop.

It will be difficult for Mr Market to develop that skill. He really, really, doesn't like to be wrong, and – even when he obviously is – he struggles to admit it. Danny Kahnemann and Amos Tversky taught us long ago that being wrong feels a heck of a lot worse as being right feels good; and there is nothing special about sell-side analysts in this regard.¹ They are not immune from prospect theory.

Many of us are already keenly aware of the obvious institutional biases that impact decision making by equity analysts, particularly for well-paid folks at bulge bracket banks. When we then throw in risk aversion in the domain of gains (or risk seeking behaviour in the domain of losses), one can start to see just why – empirically – the sell-side equity analyst community (in the aggregate) has trouble adding value.



I think I got it.

Our view is that the key drivers for this phenomenon are driven by biases. We believe that most of the individuals within that community are anchored to their previous views, disregarding disconfirming information, herding around each other, and committing a cornucopia of behavioural mistakes that prevent them from picking stocks accurately.

But you know what? So are you, and so are we. Decision making mistakes are not merely the domain of brokers at investment banks. The buy-side environment is arguably constructed with even more barriers preventing the right decisions (or ensuring the wrong ones) than the sell-side.

If you are a junior analyst at a big, bureaucratic fund management firm, it is extremely difficult to pitch an idea that the “smartest” (or at least loudest) folks out there have already concluded – in the immortal words of Gordon Gekko – is a dog with fleas. The idea will not only sound stupid, but if it doesn't work you'll probably be fired; and if it *does* work, people will just think you were lucky. It is so much easier instead to just pitch a “winner” at all-time highs. If the winner continues higher, you're a genius surrounded by like-minded geniuses; but if it falls from grace, you're okay, because every other “smart” guy out there liked it, and everyone else is suffering too.

These psychological and institutional biases don't simply afflict the young or less experienced, they affect us *throughout* our careers. It's really, really difficult to see, let alone process, disconfirming evidence. Moreover, our biases are reinforced if we communicate our investment ideas to the outside world. As Charlie Munger famously stated:

“If you make a public disclosure of your own conclusion, you're pounding it into your own head.”²

So our view is this: if more than one of our friends thinks we've lost our marbles over a particular idea, we think there is a chance that we are onto something. We believe stock prices reflect opinion first, and fundamentals second. If it feels awful and nonsensical and embarrassing to own something, then we remind

¹ Kahneman and Tversky: *An Analysis of Decision under Risk*, *Econometrica*, Vol. 47, No. 2 (Mar., 1979), pp. 263-291

² *The Psychology of Human Misjudgement*, Charlie Munger, Speech at Harvard University, June 1995, and here is a nice animated link to the speech: <https://www.youtube.com/watch?v=7-fe01CA3vc>

ourselves that it feels awful for the market too; and the share price of that awful, nonsensical, embarrassing thing is more than likely reflecting the consensus view.

As such, if you're having trouble sleeping, you probably have a more optimal portfolio than if you're getting seven hours straight a night. This of course is not to say that if a stock has done well, that it can't keep doing well; nor should we assume that a long-term loser is necessarily going to recover. Moreover, we should all be happy to own something Mr Market already likes if we think that even he is underestimating the fundamental upside. Yet, speaking broadly, it is the non-consensus perspective that is likely to win out, more times than not; and it is only the non-consensus investor who has a chance to outperform.

The views and opinions expressed in this post are those of the post's author and do not necessarily reflect the views of Albert Bridge Capital, or its affiliates. This post has been provided solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The author makes no representations as to the accuracy or completeness of any information in this post or found by following any link in this post.