

D&A: Debiasing and Alpha

We manage a concentrated portfolio of investment ideas. We, essentially, try to be objective about identifying specific instances where Mr. Market may be overreacting or underreacting to particular fundamental phenomenon. In one of our earlier pieces¹, we mentioned this:

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 behavior 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. 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.

In other words, the job may be as much or more about mitigating our individual biases than it is about identifying others' mistakes. But this is incredibly difficult to do. Danny Kahneman himself, he who identified many of these biases in the first place, states that awareness of the bias doesn't prevent even him from making many of the same behavioural mistakes we all make.

In fact, Danny has been even more damning about our industry. In our "Hunting for Alpha" piece, we mentioned²:

In Thinking Fast and Slow, Daniel Kahneman wrote of trips he made with Richard Thaler to visit (and evaluate) different investment firms. Initially, he was baffled by the industry, and his view had evolved to this:

"...my questions about the stock market have hardened into a larger puzzle: a major industry appears to be built largely on an illusion of skill. Billions of shares are traded every day, with many people buying each stock and others selling it to them. Most of the buyers and sellers know that they have the same information, and they exchange stock primarily because they have different opinions. What makes them believe they know more about what the price should be than the market does? For most of them, that belief is an illusion."

He then describes that it is psychology that drives the illusion. He describes that we all are part of a "powerful professional culture" that can "maintain an unshakeable faith" in any proposition, "however absurd", because that faith in skill over luck is "sustained by a community of like-minded believers." He continues with the primary driver of this faith:

"The most potent psychological cause of the illusion is certainly that the people who pick stocks are exercising high-level skills. They consult economic data and forecasts, they examine income statements and balance sheets, they evaluate the quality of top management, and they assess the competition. All this is serious work that requires extensive training...but unfortunately, skill in evaluating the business prospects of a firm is not sufficient for successful stock trading, where the key question is whether the information about the firm is already incorporated in the price of its stock."

¹ <https://www.albertbridgecapital.com/drews-view-archive/2018/6/4/career-risk-alpha-and-contrarian-investing>

² <https://www.albertbridgecapital.com/drews-view-archive/2018/6/18/hunting-for-alpha>

We agree with Danny's premise, but perhaps unsurprisingly disagree with his conclusion. We think he's left the door open to the notion that a stock price can incorporate the wrong information. We also believe that this can happen due to the very same biases that Danny has identified himself. In that same piece, we mentioned:

But what if the stock price is incorporating the wrong information? Perhaps Kahneman is leaving a small crack in the window for all of us stock-pickers out there. It was Kahneman & Tversky (1979) themselves that showed us how we all become risk seeking when facing losses and risk averse when facing gains. This observation in fact became the theoretical underpinning behind the intermediate-term momentum phenomenon. The authors essentially were telling us that human beings (and perhaps Mr. Market himself) incorporate the wrong public information. Maybe ignoring the wrong information and focusing on unbiased analysis of the right information is the only way to be skillful in stock trading?

We followed up on this line of thinking in another piece³:

So with that, let me re-state my favorite metaphor for what we do here. We are sitting at a poker table, playing five-card draw against other active managers, and they represent Mr. Market. In this game, each of us has the exact same cards as the other players. Each card contains some piece of information about the company in which each player is considering investing. The winner(s) will be the one(s) who correctly identify which four cards don't matter, and which one does. The loser(s) will be the one(s) who misidentify the importance of each card – the importance of each piece of public information.

So how can we attempt to capitalize on the biases of others without suffering from the same maladies? Well, we have some remedies. We know we can't cure ourselves entirely, but we hope they work, at least a little. But before we share them, we wanted to share two things that cause our biggest biases, and why these biases can suddenly appear in our investment process.

We Can Do Too Much Work

We are not trying to pat ourselves on the back here, anything but that. Some of our biggest losers have been names we knew better and longer than many others in the portfolio. There are many ways a deep dive can trip you up. You spend days and nights for years getting to know a company inside out, and in that process you can lose track of the job. We know this is debated by many, but our strong view is that our job is to pick stocks, and that is sometimes very different from picking companies. So, how can too much work trip you up? Well, for one, informational edges are scarce, and becoming even more so. Believing otherwise can screw things up. This is not the game. When we start thinking that this is the game, we have already lost.

The game is being objective about the information you and everyone else has. If we've spent days and nights for weeks, months and years modelling a company, is it possible that a sunk-cost bias is creeping in? Is it more likely that we start suffering from a representativeness bias, becoming overconfident simply because we've seen the same information over and over again? Is it possible that we've become more anchored to our view?

We wrote this in one of our first blog posts⁴:

"As we investigate fundamentals, much of our work revolves around meeting with management teams, and developing conviction in their ability to steer a business down the road. We've certainly been guilty over the years of becoming slightly too enamoured with a specific investment idea or management team on occasion, and doing so of course led to a clouded view, which we'd rather avoid.

To put it simply, there is very little upside to becoming married to a particular company or management team. This might make sense on the sell-side, where strong corporate relationships can lead to profitable banking business. However, with apologies to Lionel Richie and Diana Ross, there is no room for endless love on the buy-side."

³ <https://www.albertbridgecapital.com/drews-view-archive/2018/7/16/data-science-and-alpha>

⁴ <https://www.albertbridgecapital.com/drews-view-archive/2017/10/16/lionel-ritchie-and-management-teams>

We Think We Are Smarter Than We Are

This naturally breeds overconfidence, which leads to all sorts of problems, and it in turn leads to the mother of all biases. In another piece⁵, we highlighted the prescient Charles Ellis,

As Charles eloquently states (way back in 1975):

“The more important (success) is to (the stock-pickers) self-esteem and sense of inner worth – the more tenaciously he will hold on to old concepts, and the more insistently ignore or reject new evidence that conflicts with his old and familiar concept of the world.”

Moreover, perhaps counterintuitively, he adds that the problem is even more acute for higher-achievers:

“This behaviour is particularly common among very bright people because they can so easily develop and articulate self-persuasive logic to justify the conclusions they want to keep.”

Of course, fast forward by 40+ years, and we all know this as confirmation bias.

And this one, confirmation bias, is the cancer of biases.

So what is our treatment regime? Well, it's the four P's. Our four P's, anyway. We steadfastly follow a consistent **process**, built around our steadfast **philosophy**, we **pre-define** how and why we may lose money, and we only **partner** with investors who thoroughly understand and, importantly, embrace our approach.

Process

Many of you will have read more than you care to about our process, so we will be quick here and borrow a snippet of it here from “We’d Rather Not Sleep”⁶:

We must expertly and rigorously analyse and predict company fundamentals, and do so objectively; and we must discover a behavioral bias that is preventing Mr. Market from doing the same.

If that sounds simple, that's because it is. The work required is onerous, arduous and time-consuming, and de-biasing ourselves is a difficult pursuit that requires constant attention; but these two basic rules of engagement are fairly straightforward.

Debiasing Tool 1: Do not deviate from the process, even if every bone in our body wants us to do so.

Philosophy

We have a culture that encourages making mistakes. That's right, we do. That's the only way for it to be okay to identify them. In one of our other pieces we discussed the mistakes that Hank Aaron made⁷:

“Hammerin’ Hank” hit 755 home runs, eclipsing Babe Ruth’s 714, but he is also third on the all-time list for grounding into double plays. With a runner on first, Hank went to the plate expecting the possibility of one or the other. If he truly never wanted a remote chance of grounding into a double play, he never would have hit a home run. Instead, he wanted a chance to ground out, embraced the risk/reward, and with that mentality, over a long and successful career, he hit over twice as many home runs as groundouts into double plays.



Another double play? That's okay.

⁵ <https://www.albertbridgecapital.com/drews-view-archive/2018/2/9/the-search-for-excellence-and-the-losers-game>

⁶ <https://www.albertbridgecapital.com/drew-views/2018/10/15/wed-rather-not-sleep>

⁷ <https://www.albertbridgecapital.com/drews-view-archive/2018/3/12/bill-sharpe-and-hank-aaron>

And as we wrote in “Rick Barry and Lewis Carroll”⁸:

Our view is that the willingness to be wrong is the key ingredient in the alpha recipe. Mr Market likes to hug benchmarks, hire IBM, and shoot free throws overhanded – because there is so little downside to doing so.

So, in our evaluation of value-added and team contribution, if someone isn’t shooting their free throws underhanded, or striking out often enough, they aren’t following the process. They aren’t engaged with our philosophy.

So very simply: **Debiasing Rule 2: Be wrong, you can’t be right otherwise.**

Pre-Define Mistakes

It is imperative that we define our investment thesis, and memorialize it by publishing internal research notes. We’ve written hundreds of them, in some cases dozens on the same company. We’re not just doing this to prevent (or help identify) thesis drift, we are doing this to help us identify when we are wrong. We not only write notes, we build shadow models, representing what a black-sky case might look like. We put ourselves in the shoes of the person on the other side of the trade. If we’ve done all those things beforehand, we’d like to think that we don’t suffer from as much confirmation bias as our peers. Is the buy case getting stronger? Good! Is the sell-case getting stronger? That’s good too; we can move on, and hopefully lose less on our losers than we make on our winners.



Yeah, let's move!

Debiasing Rule 3: Write short cases for every stock we want to buy.

And as we continuously test our theses, we try not to be encumbered by the price we paid for a stock, or its tenure in the portfolio. And we hope we are capitalizing our written work on both the long and short side, and that it helps us to objectively answer the following question: If we were launching our fund today, would we go out and buy exactly the same amount of this stock at this price? If the answer is no, we immediately start making a change.

Partnership

Finally, and this one took me the longest to understand, is the importance of aligned partnership. We manage money for our partners. If our partners have different time horizons, or different volatility expectations, or different goals, then it affects us. No offense to any readers out there, but we do not work with any fund-of-funds. There are certainly some good ones, and some very good analysts at many of them, but they broadly have different goals and incentives than a charitable foundation has. If a manager were to call us up the first week of January, and ask how the year is starting off (it happened in a former life), even if we tell ourselves otherwise, it affects our decision-making.

We spend a lot of time with our potential partners highlighting and discussing our bad periods, our mistake-embracing culture, our concentration risk, and our episodic volatility. Our process needs to be aligned with investors with the time horizon and mindset to underwrite that volatility. Moreover, our new investors are soft-locked for three years and our management fees *fall* over time. For those that care about that kind of thing, we have alignment. For those that don’t, that’s okay too, we just move on.

Debiasing Rule 4: Learn what our partners want, educate them about what we do, seek alignment, and reward them for tenure.

When we are working for our kind of investor, it is more likely that we end up being the investor that they want us to be.

⁸ <https://www.albertbridgecapital.com/drews-view-archive/2017/11/9/rick-barry-and-lewis-carroll>

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