Investment discipline

Investment discipline is not about knowing when a share is about to rise or fall and, therefore when is the best time to buy or sell it.

Investment discipline should not be about attempting to out perform the market on a daily basis, since the market is not always the best manager of risk and return.

While a market may be efficient in matching demand and supply given the information available in the market place, its ability to correctly price risk is limited by the human condition, fear and greed, and by its ability to value risks to the ability of assets to meet future liabilities. Since the average human being is marginally irrational when it comes to investment decisions and since liabilities are not normally taken into consideration within the valuation decision, markets are not as efficient as they could or should be. This provides opportunities for those disciplined enough to understand, to value and to manage both risk and return.

Investment discipline is the identification and management of value and not the identification and management of share price movement; value means buying the future earnings of a company at the cheapest possible price; rising share prices means falling value and falling share prices means rising value.

There are thee main investment disciplines which offer value in terms of either their ability to out perform, or provide a below average risk, or a combination of both. These are value, growth and conservative investment disciplines

Before we can truly understand investment discipline we need to understand why we invest in equities in the first place.

What is it in fact, that we are buying? When we are buying equities we are buying the future profits of companies that operate in the economy. If a company did not earn more than we could get on cash, we would not invest in it. Therefore, the profits that a company makes has to be above the return on cash and lower risk investments.

Because of this, by buying an equity, we are really buying the additional return that an equity investment provides above the return on lower risk investments.

But why do we need a discipline when buying and selling equities? Because the amount of additional return we can get by buying an equity depends on how much we pay for our shares in a company, we need to be able to value companies and, know when a share offers value or not. This is investment discipline.

Investment discipline relies on the ability to value investments, to understand investor psychology and to focus on the underlying value of investments purchased, retained and sold and to view dispassionately the short term movement in share prices.

Many investors and many investment managers do not have the important prerequisites of investment discipline. Many are swayed by the crowd and what others are doing.

Does investment discipline always = out performance? No, it is virtually impossible to out perform the market at all points in time and under performance if you are following a strong investment discipline is, at times, guaranteed. Understanding why this is the case is important for investors and is discussed at length right throughout this website.

Which investment style is best? In the end it is not about investment styles, but about valuation and discipline. Providing your manager's assessment of valuation and valuation risks are broadly correct and, the resulting allocation is properly managed and relevant to your financial needs, your portfolio should have a good chance of achieving its stated investment objectives.

Nevertheless, different styles and different market components all exhibit periods of out performance and under performance over time. No one style or discipline is always dominant, but some styles and disciplines are more appropriate for investors who are either conservative or who have financial demands on their portfolios.

What is important, is that your wealth managers are aware of these issues, and are able to address the realities of valuation within portfolio management.

But, is active management really viable or should we all buy the index? Index investments are suitable for investors who do not want to risk under performing the index, whatever the longer term benefits of a longer term active management style, but they are not a replacement for those who can stomach contrary investment disciplines.

However, it all depends on whether your advisors have the necessary investment discipline. As noted, not everyone who manages money or who even knows how to value assets has the dispassionate attitude towards short term performance that is needed in order to successfully negotiate markets.

While most investors and most managers would be better off with an index approach, this does not mean that investment discipline is dead. Those who can value, who have the intellectual freedom to adapt to changing market relationships and those with investment discipline can outperform. But mathematics still states that it is impossible for the average investor to outperform the market.

Asset allocation: is this the new investment discipline? No, asset allocation is not an investment discipline but it is often treated as such by much of the financial services industry.

The TAMRIS Consultancy believes that the asset allocation that you receive from your manager should come from a bottom up valuation analysis of either the stocks, the markets or the components to which you are allocated. Unfortunately much of the asset allocation followed by the industry is based on statistical analysis of historical risk and return.

Asset allocation is the end result of an investment process that relates your financial needs and risk preferences to the structure of your portfolio based on the asset manager's valuation process and investment style.

Valuation, allocation and management

When we value an investment we are not just valuing how much it is worth. We are also valuing how risky it is.

When we combine investments, we need to be able to allocate to investments in a manner which manages both risk and return; more importantly we need to be able to combine investments that match individual risk preferences and financial needs.

Finally, when market and security prices change, the relationship between each security's risk and return, the interrelationship between all securities' risks and returns and risk preferences and financial needs also change.

It is not just a question of being able to value investments, or to construct portfolios but to manage all these changing relationships.

If an organisation does not have a valuation, allocation and management framework that automatically, manages all these relationships, it will not be able to effectively manage personalisation.

Why Equity Investment?

As discussed in the basics of investment, the nature of assets, there are three main asset classes; cash, fixed interest and equities (often referred to as stocks or shares).

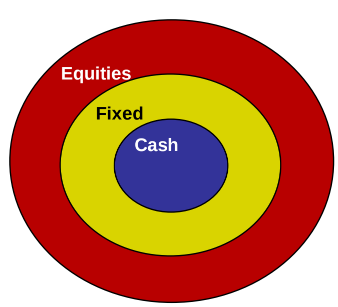
Key Point

All return, whether it be your earnings, the interest you get from your cash, fixed interest investments, government sponsored investments, stock market dividends, all come from the return on the production of goods and services.

- An investor places cash in a bank. Cash deposits are paid a rate of interest for what is really a short term loan to a financial institution.
    - The interest you get on cash is the **first component of return**.
- The financial institution lends this money to producers of goods and services at a higher rate of interest.
    - What this institution earns for taking the risk of lending the money is the **second component of return.** You the cash investor do not get this money because you are not taking this risk.
    - If you were to buy a fixed interest investment, from either the government or a company, you would get this component of return, because you would be risking this capital for the higher return.
- Producers of goods and services need to earn a return over and above the cost of capital, sufficient to justify the risk of the investment.
    - This is the **third component of return**.
- Investors who want to earn all three components of return, would need to buy stock market investments, or set up their own businesses.

Your decision

The decision, you the investor need to make, is this. Do you want one component of the return (say the cash return), or do you want to earn all three components of return?



When buying stock market investments you are buying a capital investment in a company. This capital investment gives you ownership of the earnings of the company.

Earnings

Earnings are a company's profit after it has paid all tax, all wages, and production costs etc. The earnings of a company can be considered very similar to the interest you receive on your cash account, because the interest on cash is the earnings you have received for lending the money to the bank.

The only difference between the earnings you receive from the bank and those from the company is that not all a company's earnings are paid to you. Only a portion is paid, and you receive these as dividends. The money a company retains is used to invest in the company to further growth of earnings.

When comparing the return on cash and the return on equities you should not compare the dividend yield versus the cash yield.

When comparing the return on cash to the return on equities, never compare the return on cash and the return that has happened on the stock market.

A company's earnings provide you with the opportunity for additional return over and above the return you would have got on your cash investment.

But, it is not today's earnings that will provide you with the additional return, but future earnings.

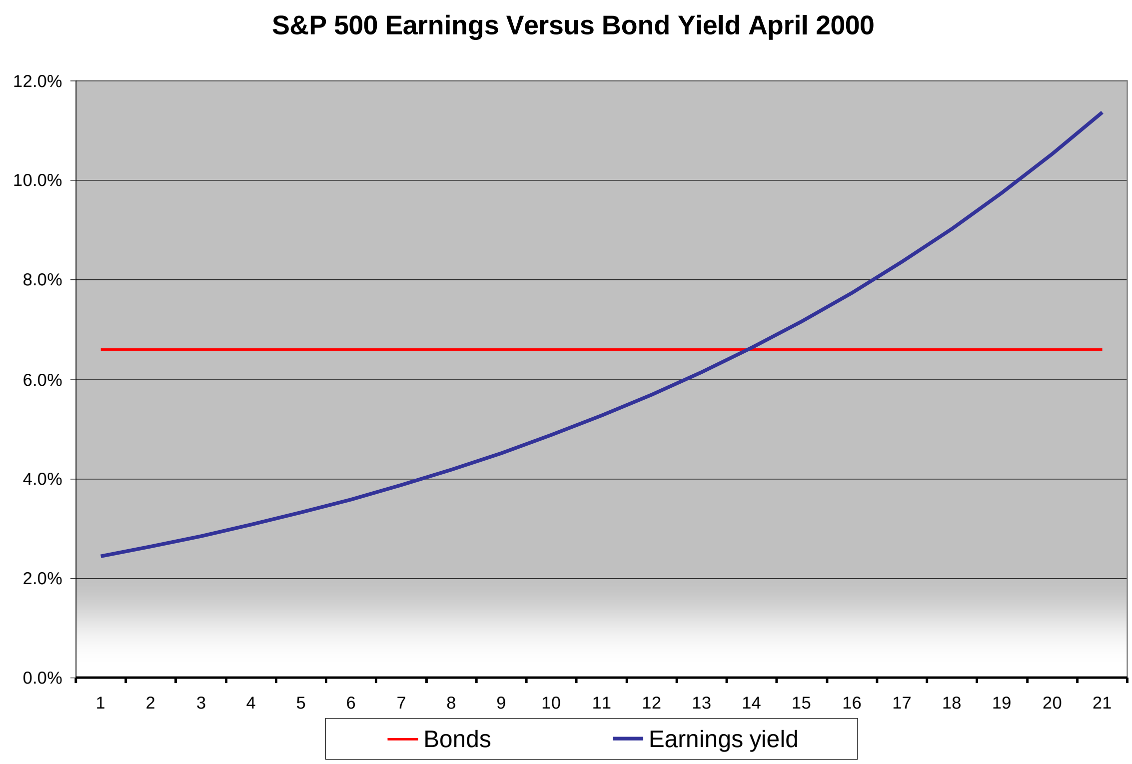
While a share is priced in dollars, cents, pounds, pence, yen or whatever the currency of the country it is bought, the actual value of the company is often shown as a multiple of the share price divided by the earnings of the company (P/E ratio).

For example if the price of a company's share was worth 20 times the earnings of company, this means for every 100 dollars/pounds/Euros you spend you would receive 5 dollars/pounds/euros of earnings.

The objective of investment is therefore to buy future earnings at the cheapest possible price. The role of investment discipline is to ensure that the money you are paying is worth the earnings you will receive.

The following chart shows the earnings on the S&P 500 in April 2000 versus the earnings on the US 10 year bond yield. At that time US markets were highly valued and the actual earnings produced by US companies were only 2.4% of the value of the market. Compare this to the bond which yielded 6.6% at the time. If US corporate earnings were to grow at an average 8% a year it would have taken some 21 years for the earnings on the market to equal the total earnings on the bond. It would have taken some 14 years just for earnings to get to that provided by the bond.

This was clearly not a good buying opportunity. This is also why you need a professional with the investment discipline and investment expertise needed to manage your money properly.



Why Investment Discipline?

Equity returns come in the form of dividends a company pays from its earnings and capital appreciation of the share price.

Appreciation in the share price reflects a number of things; reinvestment of earnings, growth in earnings, expectations of future growth in earnings and changes in interest rates which affect the cost of capital.

While the relationship between dividends and earnings has been fairly stable (companies relate what they pay in dividends to conservative estimates of what they expect to earn over time), short term movements in share prices may bear little relationship to actual earnings growth.

In the long term, though, the movement of share prices has to reflect the actual growth in earnings and the cost of capital. As such, whatever happens to the price of a share in the short term, it is the company's actual earnings that will determine where it goes in the future.

A rising share price means that an investor is paying more for the earnings of a company. This means that the difference between the return you would receive on a lower risk investment and the equity falls as the price rises. As such, the higher the short term price movement, the higher the risk you are taking and a lower level of return you will be receiving.

One role of investment discipline, therefore is to determine the value offered by the share price as well as the value relative to other shares and different investments. To be able to assess value, the major factors that determine future earnings need to be assessed.

Because a long term investor is buying the future stream of earnings, it should not matter what happens to the share price over the short term. If earnings are increasing then so will dividends and earnings per share and, ultimately so will the price of the share. Therefore if the share price of an investment falls while the assessment of earnings remains the same, the value of the investment has actually gone up.

Buying an investment because it is rising and selling an investment because it has not risen without attention to the actual value of the investment could result in an investor buying a higher priced lower return investment and selling a lower priced higher return investment.

Investment discipline therefore determines the rationale for the purchase and retention of value. Note that a company can have great growth in earnings but if the price at which you have to pay to buy a share is too high, the value attached to the share may well be insufficient to purchase it.

Investment discipline's only concern with share price movement is how this affects the pricing of the value of the investment.

This is where the standard cliché, "buy low sell high" comes from. Implementing it requires a strict adherence to the value offered by the underlying earnings and/or earnings potential of a company.

But, there are different types of value and different types of companies. Since earnings and earnings growth largely determine the movement of a share prices it is therefore important to understand that each company has different risks to earnings and different levels of earnings growth.

While these factors all affect what people are willing to pay, the basic principles of investment discipline, a focus on the underlying earnings and earnings potential of the company and its relationship with the share price, hold.

What price people are willing to pay for earnings also depends on economic conditions, the cost of capital and the demand for and the supply of shares available for sale.

Finally, in order to understand the context of investment discipline, it is also important to understand investors' natural preferences with regard to risk and return.

In general investors prefer more return to less return, greater security to less security and greater certainty of return or earnings to less. This leads most investors to focus on shares which are rising, which have risen for some time and which appear to exhibit greater certainty of return.

In truth the two major investment disciplines, value and growth, invest in stocks that have characteristics that reduce their attractiveness to investors in general; uncertainty over the size and direction of earnings and either greater volatility in price or recent negative or poor relative price performance.

The heart of investment discipline lies in understanding the consequences of the interaction of investor preferences, earnings and prices.

Equity Risk Premium

The difference between the profit a company makes on capital invested and the cost of capital is called the real "equity" risk premium. This is the return above what the owner of the business could get on a lower risk investment by investing in his business. It is the additional return for taking the risk.

This cost of capital is the rate at which a company would need to borrow the money to invest in the company, or the return an individual could get on a lower risk short term investment, such as a fixed interest security, instead of investing in a company.

The size of the equity premium depends on the share price.

Investment Discipline Under Attack

The well publicised failure of active management to outperform the market index has wrongly marginalised investment discipline as a valid framework for the management of risk and return.

TAMRIS believes that careful analysis of market dynamics, risk preferences and investment styles actually supports selective use of long term active management disciplines.

THE INDEX ALTERNATIVE

The "index fund" is a rationale solution for the majority of investors, advisors and portfolio managers with conventional risk preferences.

Nevertheless, reports over the failure of most mutual funds to out perform the index should not be a revelation.

- The majority of investors are unable to out perform the index over the long term because a) the market is efficient in matching demand and supply and, b) most investors at any one point in time are congregated around areas of highest earnings' certainty and greatest price competition.

- Many mutual funds attempt to reduce performance risk by limiting deviations from the index, limiting room for out performance.

- In Canada, management expenses can be as high as 2.75% including trailer fees. The S&P 500 was close to 40 times earnings at its peak in 2000 with an earnings yield of 2.5%. At the same time the 10 year treasury was yielding some 6.5%.

The march of the index alternative is not a reason to ditch investment discipline. It is a reason to consider whether a particular allocation component is best housed within an index.

You cannot adopt investment discipline!

For one, value investors have to be able to buy assets which others are not buying, to undergo periods of relative under performance, to take positions which many investors would consider risky and to tolerate market conditions that may be too much for many investors to stomach .

While a pure and simple index recommendation is sensible it is by no means an optimum framework for the management of risk and return.

By buying the index you are stating aversion to under performing the index and that short term performance is an issue.

Unfortunately, indexes create as many problems as they solve.

- Indexes underweight under valued areas and overweight over valued areas and as a result are more expensive than they should be. The major benefit, apart from costs, is that they avoid market timing. Indexes neither sell low nor do they buy high.

- Because the index over weights over valued components, the index is not a good risk manager.

So which index?

The major market indexes are weighted by market cap and by highest relative demand. They are not weighted by value.

Note the overweight position of telecom, technology and media stocks in each market's domestic index at the end of the 1990s and note the overweight allocation to Japan in global market indexes at the end of the 1980s and vice versa the US at the end of the 1990s.

Areas of lowest market cap, highest equity risk premiums and lowest relative demand; smaller companies, undiscovered growth and value and/or sectors at critical valuation points are under weighted.

This makes value style indexes a competitive alternative, given that value indexes out perform the overall market index over time. Unfortunately since value can also under perform the major market index over long periods of time, you need a value discipline to stomach a value allocation .

Style, market cap and ETF sector indexes are worthwhile asset allocation vehicles for those with specific allocation and management discipline and, a lower cost alternative to market timing problems for those without.

International index

If the objective of asset management is to add value then we need to be able to allocate globally. How much and to which index is a problem, since both decisions imply a valuation and allocation decision.

Global indexes amply illustrate the dangers of weighting according to market capitalisation.

Economies at the peak of their economic and market cycles will have the largest index allocation while those in recession and market troughs will have lower allocations.

Additionally, global indexes do not allow you to sell over valued components or retain under valued components. As such global indexes limit return and risk management opportunities. As with domestic market indexes, allocation to higher risk/higher return areas such as smaller companies and emerging markets is also limited.

Component index efficiency

Care needs to be taken with reference to conclusions drawn from long term performance analysis of component indexes.

For example, note the S&P Value and Growth Indexes. In fact, the top end of the value and the lower end of the growth universe represent the conservative allocation universe. These indexes also do not show the constant recycling of value or growth and the benefits of this recycling on long term performance.

Additionally, to use a simple growth index to validate the long term benefits of growth investing is also open to error. Not all stocks in the growth index are actually growth stocks. Many will be either overvalued or mature growth stocks exposed to a decline in price.

Which Investment Discipline

No one style is efficient over all time periods and, no one type of stock and no one industry specification will forever remain value or growth.

Restricting yourself to the traditional allocation universe of one investment style may affect your ability to manage risk and return at critical valuation points.

Unfortunately, many managers will adopt the mantel of a style without having the necessary intellectual freedom to continuously reinvent and reassess value in the market place.

Nevertheless, it is generally accepted that most investors are better off with fundamental long term earnings based investment disciplines.

Value has been shown to out perform the market and all other styles over the longer term, although this depends on the start date and the classification of style comparison.

In fact, larger companies, small caps, mid caps, growth stocks, value stocks and sector equivalents all exhibit periods of significant out and under performance as market demand moves from one area of preference to the next. All areas of the market therefore have a relative as well as an absolute valuation.

Genuine long term growth stocks (from start to the peak of their growth cycle) do out perform the market by a very wide margin, but not everybody is a genuine long term growth investor and not everyone buys at a reasonable price.

Diversified portfolios may benefit from a relative valuation approach, that is holding investments with different characteristics in proportion to their relative value and relative to the individual client's financial needs and risk preferences.

Portfolios can easily incorporate both growth and value components at the same time. An investment can also be both a growth and a value investment. For example, emerging markets can have both growth and value characteristics, while growth stocks can be undervalued and stocks traditionally classified as value can be over valued.

As far as which style should be the predominant style in a portfolio, this depends on the financial needs of the investor and their risk preferences.

Value styles tend to be lower risk because they invest in companies and areas which are under valued and where much of the risk has already occurred; although, areas which have seen large falls and poor performance are not always viewed as low risk by the average investor.

Value stocks, because their prices are depressed also tend to provide a higher level of dividends than growth investments and as such are often considered more suitable for investors who need a higher level of income from their portfolio.

Growth portfolios tend to be more aggressive in that the value of the underlying stocks are more sensitive to changes in earnings, and they provide a much lower yield, because prices are placing greater emphasis on future earnings than current earnings. They are therefore generally considered more appropriate for investors with no financial demands on their portfolio and more aggressive return objectives, who can afford to take a longer term investment view.

But, if you take a total return approach to investment, there is no real reason why a properly run, well disciplined, growth portfolio should be inappropriate for an investor who relies on their portfolio for income. What it will mean is that more of the portfolio will need to be in higher yielding lower risk, fixed income investments and less of the portfolio in equities.

As far as individuals with no financial demands on their portfolios, the value and growth universe is sufficiently large as to be able to incorporate investments with different style characteristics and still achieve a well disciplined, well balanced management of risk and return.

In the end, it all comes to valuation. Does the purchase discipline value current or future prospects so that the portfolio can accommodate short term stock market movements and economic risks.

In this context, the decision over investment styles is a misnomer. It is really a question of investment discipline and how appropriate that investment discipline is to the management of your financial needs given your risk preferences.

A good asset manager should know where their allocation universe, style and risk and return profile fits with your needs and your risk preferences.

To make a definitive statement of what is and what is not appropriate, or what performs best would be incorrect because in investment there are no relationships which remain constant. Values and prices change and the relationship between the value of one investment and another are likewise constantly changing.

Investment Discipline and Market Conditions

During stable economic conditions and strong investment returns, conservative investors are often induced into taking higher risks.

In the late 1990s this allowed higher risk growth investments to be incorporated within portfolios.

Conversely, poor market and economic conditions induce a move towards defensive secure stocks with low earnings growth. The risks are clear, buying high and selling low.

During periods when value under performs there is pressure to increase the quality of the portfolio, as indeed happened during the late 1990s.

Periods of strong out performance of value stocks will often force a move towards poorer quality companies as the equity risk premium on value investments narrows and dividend yields fall.

The risks here are selling low and buying high on the one hand and increasing risk on the other.

For growth investors, periods of strong investment returns and economic stability raises the price and risk of growth, eliminating the performance differential between it and the market. The risk here is to move to more speculative growth investments.

Different economic and market conditions can force managers to move outside their investment style, increasing risk and reducing long term value. While investment discipline should not adhere blindly to its beliefs, it should not be affected by short term performance considerations. A style should only move outside its boundaries to reduce risk or add value

Investment Discipline and short term performance

It is virtually impossible to out perform the stock market all of the time, over time. The only way to out perform is to act differently from the rest of the market and to allocate more to higher risk out of favour areas.

To do this you have to risk under performing the market, an action contrary to investor psychology which views under performance as a consequence of “getting it wrong”. The natural inclination is to buy investments which are performing well and sell those performing poorly.

Unfortunately for those who try to out perform all the time, the market is efficient. The demand for and supply of shares in the market is at equilibrium and represents all known information and decisions by all market participants.

While you may make a better decision than the average investor on some stocks, you may make a worse decision than the average on others. What the market does not do is tell you whether a falling stock should be falling or whether a rising stock should be rising, or whether a rising stock has risen too far and vice versa.

Efficiency means that you cannot consistently engineer significant price differentials by acting on readily available information .

The index is the weighted average of the sum of all investment decisions. Its performance is greater than the average because of commissions, spreads and timing costs.

The only way to beat the index if you are a conventional investor is to be one of the first to buy and one of the first to sell. This is market timing. The other way is to think long term and act contrary to the views and preferences of the market. In other words, investment discipline.

For further information please performance risks in the section the basics of investment.