

HHIF Lecture Series: Investment Philosophy

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Based on the Materials by Vincent Wong

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Introduction

- Series of lectures covering major areas related to investing
- Useful if you don't know much about investing
- Topics covered:
 - ▶ Investment Philosophy
 - ▶ Financial Statements
 - ▶ Discounted Cash Flow Model
 - ▶ Risk Management and Portfolio Optimization
 - ▶ Investment Funds as a Business
 - ▶ Maybe more
- Three lectures in fall, at least three in spring
- For general inquiries, contact me (alexanderrem@gmail.com)

Acknowledgements

- You don't need formal education to learn this stuff
- But you do need
 - ▶ Common sense
 - ▶ Commitment
- Tonnes of resources
 - ▶ *Ben Graham*: Security Analysis, The Intelligent Investor
 - ▶ *Warren Buffett*: Berkshire Hathaway Shareholder Letters
 - ▶ *Philip Fisher*: Common Stocks, Uncommon Profits
 - ▶ *Aswath Damodaran*: [Damodaran Online](#)
 - ▶ *Online resources*, e.g. [Investopedia](#)



Importance of an Investment Philosophy

- There is a whirlwind of investment information out there
- Much of it contradictory
 - ▶ "Markets are efficient"
 - ▶ "Technical analysis is witchcraft"
 - ▶ "Bulls make money, bears make money, pigs get slaughtered!"
- Truth is there is no right investment strategy
 - ▶ Highly dependent on personal preference
 - ★ Time-frame, risk aversion, time and energy one is willing to spend, belief in certain 'stories' (i.e. biases)
- But there is definitely a wrong strategy
 - ▶ Not doing your homework and changing strategies every time something goes bad

Different Investment Strategies

1 Value Investing

- ▶ Selecting securities trading at a discount to intrinsic value
- ▶ **This is the general investment strategy of HHIF**
- ▶ How do you know what the intrinsic value is?

2 Growth Investing

- ▶ Selecting securities with above-average growth prospects
- ▶ Not much information about the company

3 Efficient Markets (Sit-on-your-ass Investing)

- ▶ Buying an array of low-cost index funds in a variety of asset classes and making periodic contributions
- ▶ Then you won't lose much compared to the benchmark

4 Day Trading

- ▶ Making frequent trades throughout the day based on the analysis of technical indicators
- ▶ High Frequency Trading

Different Investment Strategies - II

5 Simon Says

- ▶ Follow an investing guru (i.e. Buffett, Soros, Ackman) and imitate their portfolio and trades exactly
- ▶ <http://www.youtube.com/watch?v=4YyEdny5rh8>
- ▶ But you will imitate with a delay

6 Event Driven

- ▶ Time certain scenarios such as mergers & acquisitions, divestitures, bankruptcies, conference calls, etc.
- ▶ Inside information

7 Arbitrage

- ▶ Finding and taking advantage of quantitative mispricings (usually in fixed income, derivatives)
- ▶ Hard to find in highly regulated markets

Some Propositions

- It does not take above average intelligence to understand and apply proper investment concepts
 - ▶ Awareness of one's emotional responses is far more useful
 - ▶ To evaluate the effectiveness of an investment strategy, you have to stick to it
- Finance is imprecise by nature
 - ▶ We want to use past data to forecast future data
 - ▶ How well can you predict the future?
 - ▶ Is the past data even correct?
 - ▶ This does not mean finance is useless
- Economics is a social science
 - ▶ Human behavior moves the markets
 - ▶ Automated trading also moves the markets...
 - ★ But humans write the automated trading software

Human behavior moves the markets...



Risk vs Return

- Every investment is associated with an expected return and expected risk
- Risk measured in terms of variability of returns
 - ▶ Can be forecast using investment models, e.g. CAPM, APT, others
- Higher return is usually associated with higher risk
 - ▶ 1. If you have to choose between two options offering the same return, will you choose one with lower risk?
 - ▶ 2. If you have to choose between two options with the same risk, will you choose one offering higher return?
 - ▶ Depends on risk aversion, perception of the possible outcomes
 - ▶ Why do so many people play the lottery?
- *Alpha*: risk-adjusted return
 - ▶ Expected value is zero
 - ▶ Positive alpha means "beating the market"
 - ▶ Used in evaluating an investment strategy or portfolio manager's performance

What you'll need

- Some fundamental concepts you need to learn to start investing
 - 1 Accounting
 - ★ Reading Financial Statements, Ratio Analysis
 - 2 Economics
 - ★ Macro, Microeconomic Theory, forecasting
 - 3 Statistics
 - ★ Standard Deviation, Regression
 - ★ Advanced statistical techniques
 - 4 Business Strategy
 - ★ Management, products, competition
 - 5 Common Sense
 - ★ Sometimes a theory does not apply to the real world
 - ★ It is up to you to decide if the model you use gives sensible predictions

What you'll need - Accounting

- The language of business
- Analyzing financial statements
 - ▶ Found in annual reports, SEC filings
 - ▶ Some discussion provided in reports, but created by the company
 - ▶ Crucial to understand the company's financial position
 - ▶ You should always look at financial statements if you plan to invest for the long-term
 - ▶ Are the numbers right?
- Financial Ratio Analysis
 - ▶ Used to compare similar companies in terms of their profitability, financial health, efficiency, value, etc.
 - ▶ Used to forecast how company will do in the future
 - ★ This is the key idea in the Discounted Cash Flow model
- This will be the topic of the second lecture

What you'll need - Economics

- Macroeconomic Theory
 - ▶ Studies how economy's levels of employment, production, and growth are determined
 - ▶ Studies economy **as a whole** and how effectively scarce resources are allocated
 - ▶ Global trade, foreign exchange, fiscal and monetary policy
- Microeconomic Theory
 - ▶ Studies the economic behavior of individual decision makers: consumers, firms, managers, households, etc.
 - ▶ Studies specific markets and how scarce resources are allocated there
 - ▶ Three tools: *constrained optimization*, *equilibrium analysis*, *comparative statistics*
- Top-down approach to investing
 - ▶ Look at the big picture, i.e. macro variables, then choose the best industries to invest in, then the best stocks in those sectors and decide when to invest
 - ▶ Bottom-up approach: some companies in "bad" industries are good investments

What you'll need - Statistics

- Statistical analysis involves collecting and analyzing data and then summarizing it into a useful, numerical form
- Statistics is a crucial part of modern finance
 - ▶ Modern Portfolio Theory
 - ★ Risk measured in terms of Standard Deviation
 - ★ Capital Asset Pricing Model, Mean Variance Portfolios
 - ▶ More Advanced Models
 - ★ Arbitrage Pricing Theory - Regression on various factors
 - ★ Time Series Regression
- Statistical models are hardly ever 100% accurate
 - ▶ You are using past data to forecast the future
 - ▶ Gaussian Copula - "The Formula that Killed Wall Street"

What you'll need - Business Strategy

- Before investing in a company, you need to understand how it operates
 - ▶ Management competency and past performance
 - ▶ What is the product? What is the strategy? Who are the customers?
 - ▶ How will the company outperform its competitors?
- 3 of 15 Fisher's questions (from Common Stocks and Uncommon Profits); also found [here](#)
 - ▶ Does the company have products or services with sufficient market potential to make possible a sizable increase in sales for at least several years?
 - ▶ How effective are the company's research-and-development efforts in relation to its size?
 - ▶ What is the company doing to maintain or improve profit margins?
- Combine business strategy and financial statements analysis

What you'll need - Time Value of Money

- \$100 today is not worth the same as \$100 a year from now
- Compounding
 - ▶ For example, money in a savings account with an interest rate r
 - ▶ If the interest is paid annually and *reinvested*, after t years, the investment will grow by $(1 + r)^t$
 - ▶ What if interest is paid monthly?
- Discounting
 - ▶ You will receive \$1000 three years from now; how much is it worth today? Probably less...
 - ▶ Assume annual interest rate is r
 - ▶ **Present value:** $\frac{1000}{(1 + r)^3}$
 - ▶ What if you will receive several payments at different dates?
- This is another key idea in Discounted Cash Flow Model
 - ▶ And other pricing models, e.g. bond pricing, option pricing, etc.

Most important words in Finance?

”Investment is most intelligent when it is most business-like”

-Benjamin Graham

What you'll need - Putting it all together

- Making good investments using the aforementioned concepts properly
- Common Sense
 - ▶ Any theory/model/tool may be useful, but only when you understand how it works and if it is applicable
 - ★ Sometimes it is blatantly obvious that the model does not work
 - ★ Sometimes you realize this only after it failed
 - ▶ How much of your strategy is gut feeling?
 - ▶ Is the market a zero-sum game?
- Hard work
 - ▶ Read the financial news every day
 - ▶ Perform financial analysis yourself
 - ▶ Learn by yourself
 - ▶ Investment Industry is extremely competitive

Common Traps

- Beware of outsourcing your analysis (sometimes even data collection) and blindly following other's opinions
- Falling into the trap of the 'mania'
 - ▶ Market behavior is akin to a herd, everyone moves in the same direction, missing valuable opportunities
 - ▶ The person in front of the herd wins
- Greatest returns are earned by selecting investments after careful consideration and analysis
- **"They know something that I don't"**
 - ▶ Do your own homework!
- **"The stock has gone up so I should buy it"**
 - ▶ The stock **"has gone"** up

Any Questions?

Next Lecture: Financial Statement Analysis
Friday, November 5, 6-8 p.m., South Dining Room, Hart House

Image References

- Warren Buffet Photo - Glide Foundation, via eBay
- Investopedia Logo - from <http://investopedia.com>
- The Economist Cover - from <http://visionarymarketing.wordpress.com/2008/10/21/credit-crunch/>