COMMON SENSE AND PROPORTIONS*

2018, Annus Horribilis?

"Economic theory should not be expected to produce universally valid laws. The slavish imitation of natural science inevitably leads to the distortion of human and social phenomena. What is attainable in social science falls short of what is attainable in physics." **- Georges Soros**

Guillaume Dolisi

Laurent Pla

Following our last letter in July 2018(**), we want to take advantage of the latest market events to continue our question-and-answer session. The last six months of the year, like the first six, put numerous investment approaches to the test: some which we use and others which may have made news.

These last six months also (and especially!) caused the performance of many strategies to plunge from a disappointing level to a truly bad level, with absolute or relative drawdowns never attained in the past twenty years. We will try to understand how 2018 proved to be a particularly "horrible" year for a large proportion of active management, even though the magnitude of the equity market downturn was by no means really exceptional.

We will therefore once again adopt as a basis research and thoughts already conducted by some of the greatest investors. In this letter, we will focus in particular on a concept dear to Georges Soros, the "reflexivity" of financial markets, which is very useful to explain the recent setbacks of numerous investment management strategies.

**** The purpose of these letters is to share ideas and points of view on a variety of investment-related subjects, whilst attempting to show common sense and keep a sense of proportion. In the field of investment management, as in many others, knowing that something exists does not mean being capable of measuring it. The content of this document reflects the authors' views at the time of going to press and is accurate to the best of their knowledge.***

*****https://www.via-am.com/common-sense-and-proportion-fund-managers-letter-july-2018/***

With global equity markets down by about 10%, in what ways was this year especially difficult for active management strategies?

It is true that there is nothing exceptional about the scale of the decline in 2018. It is far more **unusual to see so many assets and strategies post negative performances** in a single calendar year. This has never occurred in the past 20 years, despite five major equity downturns, of between about 25% and 55% (2015/2016, 2011, 2008/2009, 2000/2003 and 1998). However, in each of these periods, a few assets or strategies managed to post very significant rises.

This year, the situation is different. While the MSCI World AC gave up 10%, **the other major asset classes also lost ground**. For example, the *Global Aggregate* bond index gave up 2% and *High Yield* credit 3%. Most defensive assets were also in negative territory: Gold and 10-year *US Treasuries* declined by 6% and 2% respectively. Moreover, hedging dollar exposure would have cost euro investors an additional 3%. Ultimately, only cash in dollars and German Bund managed to be significantly positive.

At the same time, and despite their potential ability to hedge market risk, **the main alternative strategies (*Absolute Return*) did not work either**: the dollar-denominated HFRX *Global* index lost 7%, *Long/Short Equity* 10%, *Market Neutral Equity* 3%, *Systematic CTAs* 5% and *Event Driven* 11%!

In addition to this, there was a setback for the **main *bottom-up* equity investment factors**, supposed to be weakly correlated with one another and which, in a hedged against market risk format, gave up between 1% and 10% in Europe, for example (source: SG facteurs Europe).

In short, to quote Harry Markovitz, diversification is perhaps "the only free lunch in markets", but in 2018 we were treated to a good helping of food poisoning!

And yet, a few rare strategies, or at least some fund managers, nevertheless **managed to achieve reasonably good results.** Trend following and carry strategies were able to work in the fixed-income and currencies universe. And those that worked best were more specifically the **concentrated and top-down contrarian approaches**.

In general, 2018 was a year more conducive to concentrated and directional approaches, and **the notion of price paid did not really matter.** So conventional *value* approaches lagged well behind. Until July, **the FAANG phenomenon** prevailed, with stocks advancing by more than 50%, exceptional for large/mega caps (and not small-cap biotechs!). Some of them could justify their valuation, but clearly not all. Since August, **large so-called defensive companies** such as Nestlé, Novartis, P&G and Coca-Cola have driven the market. Their valuations, too, are very far from attractive (about 70% above the market), for an average profitability just in line with the benchmarks. The best companies always justify valuation premiums, but **there is a limit above which the term "defensive" may seem contradictory**!

Beyond the performance of the main assets, numerous investment strategies supposed to be weakly correlated have posted very disappointing performances. How can this be explained?

Before going into the difficult exercise of explaining performance, we would like to give a reminder that we are able to **make hypotheses**, but definitely not present certain facts. The subject is far too complex and impenetrable for that.

First, we believe that if, in the long run, what causes fluctuations in an asset or a strategy is generally related to its **intrinsic quality** (value creation), it is the **imbalance between buyers and sellers** which determines prices in the short term. This means, for example, that a very good company can fall far more than a less attractive one simply because there are far more sellers than buyers. What is worse, since price formation is nonlinear (see our previous Letter), a stock's rise from €100 to €200 can take place in 100 trading days with an average volume of €10m each day (a cumulative total of €1bn), whereas the subsequent fall from €200 to €100 can take place in five days with a cumulative volume of €200m. And what is true for a stock is also true for a diversified basket of assets or an investment strategy.

It seems to us likely that **we have recently been faced with a major imbalance between buyers and sellers**, in a market which did not offer sufficient liquidity. Some analysts mention the termination of QE programmes, and this is a convincing argument, but it was already foreseeable before mid-year. Ultimately, it is clearly flow imbalances that move share prices.

Of course, this view **runs counter to the price equilibrium theory** which underlies the market efficiency hypothesis. Here we want to go back over some of the theories outlined by **Georges Soros**, and his **understanding of the interaction between thought and reality** which exists in social sciences such as financial market analysis.

First, there is the idea that markets are made up of participants who have a partial and distorted perception of the world, i.e. the **principle of fallibility**. Next, there is the idea that this distorted view can also significantly influence reality, i.e. the **principle of reflexivity**.

Fallibility is already fairly well understood, and many investment managers recognize the opaqueness of the subject analysed, the infinite number of parameters and the effect of our cognitive flaws on decision making.

Reflexivity acts more perniciously and remains hard to grasp. It is the fact that what participants think or do has a direct influence on the markets analysed, with extremely powerful feedback-loop effects. **Participants' mistaken perception will directly influence the underlying.**

Consider a topical example. If a sufficiently large number of market participants think, (at least) partially incorrectly, that the Bitcoin, whatever be its level, is capable of replacing conventional currencies, those participants will drive up its price in a potentially exponential manner (*boom*). Then, rather like in an influenza epidemic when all the potential sufferers have been contaminated, there will no longer be any buyers, but only sellers, who will be very drastically immunized (*bust*).

The Bitcoin is an extreme example. More seriously, many investors (and not only quants like us) have developed **two very powerful beliefs** in the past decade, on highly statistical bases. First, that **diversification** is a performance driver, and

second, that certain **performance factors** (*Value, Momentum, Low Vol,* etc.) can explain a large proportion of performance and that it is possible to profit from them in a fairly stable manner by diversifying them. We believe that these ideas are broadly substantiated, and one bad year cannot (yet) wipe out decades of empirical evidence. However, the fact that a growing number of investors may have all oriented their investment management in the same direction may very likely have **influenced the performance of these approaches.** First positively, with ever more buyers who self-fulfil their performance targets. Then very negatively, when a need for deleveraging forces the same market participants to reduce positions that have become too popular (crowded).

Here we will set ourselves apart from many of our quant colleagues! Admittedly, we often adopt similar approaches, but at the same time we are still **ill at ease with a form of scientism**. Quantitative fund managers tend to over-stress their scientific abilities and knowledge (e.g. the number of PhDs in nuclear physics), even though most of the theorems valid in the hard sciences become fragile or ineffective, even dangerous, in the soft sciences (such as market analysis). We think that although diversification and factor-based approaches have a lot of merit, **explaining the variance of a portfolio is not equivalent to explaining its performance**, still less predicting it. Things are always more complicated.

"To a man with a hammer, every problem looks like a nail."

- Charlie Munger

We consider it highly likely that in 2018 factor-based and diversified management styles were victims of their success. So here we will contradict what may have been said or written by some of our colleagues, who in our opinion commit **an error of analysis.** To be more precise, we may mention one of the stars in our sector, Cliff Asness of AQR, and in particular one of his excellent most recent papers, *Liquid Alt Ragnarök* (1). We would like to specify clearly that we are admirers of the author and of the success of AQR, and that we very largely share the ideas that are outlined in the paper. Simply, Cliff Asness and many other "Risk Premia" managers **refuse to see** in their recent poor performances **a problem of "*crowdedness*".**

One of the arguments put forward is that we have already known similar situations in history for each of the factors taken separately, and that, for some of them such as the value factor, the premium always appears at a "normal" level (valuation gap between the most expensive stocks and the least expensive ones).

And yet, the fact that very weakly correlated factors do not work jointly with others during a sufficiently long period has precisely not occurred in the past. The reason for this is fairly simple: these factors support fairly different and sometimes opposite investment bets. However, if **a sufficient number of investors** invest at the same time in these factors which are in theory not linked, in the end, precisely, they create links and **distort their non-correlation properties**. Accordingly, when they have to trim their positions, these investors will sell the same underlying assets at the same time, and restore a correlation between them. We are at the heart of reflexivity, the distortion of market phenomena by the analysis, beliefs and then the action of market participants. We admit that this argument is more empirical than statistical, but the absence of statistics should not (always) prevent us from forming an opinion. Precisely, we are not in Newtonian physics.

> ***Referring to the markets: "I can calculate the motion of heavenly bodies, but not the madness of people."***
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> **- Isaac Newton**

We also consider that the argument of the attractiveness of the value premium is partially incorrect. Clearly, the gap between the most expensive stocks and the least expensive stocks is very large, even if it is not at its historical peak (75% currently vs. 20-year peak of 85%, calculated on a global developed universe of stocks, comparing least and most expensive quintiles based on P/E ratio). However, it is not this gap that is monetized by value factor investing, but only a small fraction (about 3% or 4% per year). Accordingly, the spread need only narrow to 80% instead of 85% and there will no longer be anything to gain, at least statistically.

Finally, these quants explain that the assets under management in similar funds are too small to influence markets. We find this argument rather succinct. First, declared factor-based management (Risk Premia, Smart Beta, etc.) is only the visible tip of the iceberg. The great majority of fund managers use the same principles at least partially and thereby contribute to the same problem. Most importantly, as we already explained in our last letter, price formation is not linear, and only a few very aggressive buyers or sellers are needed to cause variations in a stock or a strategy (in proportion to the liquidity of the underlying asset or assets).

> ***"There are two possible ways to take advantage of the recurring wide fluctuations in stock prices, by way of timing or by way of pricing"***
>
> ***- Ben Graham***

So what approach should we adopt for our investment strategies? Should we have a neutral approach and use only ETFs, or even be in cash? Should we simply give up factor-based approaches and diversification?

Here, we can be very clear: there is no **neutral approach** from an absolute or relative standpoint. Holding cash on an account, e.g. a remunerated current account, is indeed an **investment decision, which entails "real" risks**. This position can be defined simply as a bet on the fact that, over a given period of time, other assets will rise by less than the interest rate on the account. There is therefore a risk of lost earnings if assets rise more. Not to mention the possibility of losing everything in the event of a collapse in the value of money. The latter risk is admittedly very unlikely in the short term for an investment denominated in dollars or euros. However, history teaches us very clearly that fiduciary money (i.e. money not based on real assets) can depreciate sharply in just a few days (Weimar Republic) or over several centuries (Roman Empire), especially when there is a problem of sovereign debt and central-bank balance sheets, with deficits that are out of control (see our last letter).

Regarding ETFs, it is harder to form an opinion. There is probably not **an "ETF problem" in general**, but more certainly specific risks depending on the type of asset, its size, underlying liquidity, etc. It seems fairly clear that, like for some of the assets and strategies mentioned earlier, if a great majority of investors start acting in the same way, they distort the properties of their investments. For conventional equity ETFs, weighted by market capitalization, this amounts to procyclical behaviour which will **foster investment in companies irrespective of their**

fundamentals. Due to the pressure, these stocks will therefore move away from their equilibrium prices and are likely to **return to them** very suddenly if the movement is reversed.

As regards factor-based and diversification approaches, everything should not be thrown out directly. Once the *crowdedness* effects have subsided, the major principles of these approaches should work again. Besides, we believe that all investment management approaches, especially those which have worked for a long time, go through difficult spells. It's fairly simple: the better a strategy works, and works for a sufficiently long time, the more participants it will attract, creating a cyclical phenomenon of over- and under-performance.

Consider the example of one of our equity investment strategies. **In our VIA Smart Equity funds,** we endeavour to replicate one of the best approaches in history, giving priority to companies which combine a high economic profitability, a good level of confidence in the sustainability of that profitability and a relatively attractive valuation. In the past, this strategy has seen very positive spells and others which were far less so, the conventional pattern being that the better it works, the more participants it attracts. **Benjamin Graham precisely characterized this dichotomy,** moreover: market participants having a long-term fundamental view (**Investors**) will always be exposed to this type of stocks; in contrast, those whose technical perspective is short-term (**Speculators**) will come and go based on recent performance. The latter will therefore accentuate performance positively, and then negatively.

"An investment operation is one which, on thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

- Benjamin Graham

The future will possibly diverge completely from what has been seen in the past, but we do not think so. As opposed to highly statistical models, this approach is based on very mechanical principles: if you invest in companies which create and continue to create the most value (maximum discounted revenues vs. the replacement value and economic life of economic assets), at an attractive price (for a minimum of overall liabilities), **that "ultimately pays off"** (see our next letter on the Value Creation Line, VCL! Let us "simply" show patience.

"A good company generates more cash than it consumes, ... (and is) virtually certain to grow in value."

- Benjamin Graham

Lastly, a certain amount of humility remains necessary for all the strategies which have worked recently, "through talent or luck". Precisely because a clearly identified strategy or asset class which has worked recently could easily become the next "victim" of the phenomenon of reflexivity. It's a perpetual conundrum!

Finally, it is now three years since you made changes in your fundamental equity strategies by including accounting normalization. Has this been conclusive?

On the time scale of **in-depth financial analysis** represented by accounting normalization,

three years are still too short a time lapse to be able to draw definitive conclusions. But the results are in line with our expectations, with an average annual outperformance of approximately 2% compared with the use of conventional accounting data. This year, the outperformance was not sufficient to make a difference compared with the benchmarks; and yet, the fact of going always deeper into the analysis of value creation phenomena enables us precisely to face up to difficult years with more composure.

During the past 10 years, we have endeavoured to move away from the attempt to model financial markets through increasingly mathematical quantitative approaches decorrelated from the real economy. We of course use technology, but mainly **to gain productivity** in processing the fundamental data.

Regarding the analysis of balance sheets and profit and loss accounts, our aim is rather to **come closer to** what is practised in the world of ***Private Equity*, but on a large scale**. Very granularly, we try to clearly understand the profitability of the assets in which we invest, and the price (total liabilities) that we pay. Of course, this is by no means a guarantee of performance, but is clearly a factor of confidence in a cycle low.

Our in-depth research on the greatest fund managers in history has thus taught us that it is possible to achieve performances far above the benchmarks, but never in a stable, orderly manner. In the long run, there is no magic formula and it is essential to be capable of holding into positions when performance is more problematic.

"With every new wave of optimism or pessimism, we are ready to abandon history and time-tested principles, but we cling tenaciously and unquestioningly to our prejudices."

- Benjamin Graham

Conclusion

The aim of this sixth letter is again not to endeavour to minimize disappointing performances, but to take the detached view needed to have a certain sense of perspective.

A little chronological perspective shows us that market reversals are often very fine investment opportunities. Except in the event of bursting bubbles or major dislocations, a 25% decline clearly offers a (first) entry level.

As a reminder, great investors such as Warren Buffett are adepts of the "double-shot rifle" (or more). They are always invested in the best companies, but hold cash to take advantage of any declines and thus invest more and cheaply.

From 2013 to mid-2018, we have heard most investors tell us that they were looking for entry points. Go on then?

"Be fearful when others are greedy and greedy when others are fearful.".

- Warren Buffett

This is also the season to wish you and your families a wonderful year in 2019!

(1): https://www.aqr.com/Insights/Perspectives/Liquid-Alt-Ragnarok

About Guillaume Dolisi

Prior to cofounding VIA AM, he co-created and co-managed with Laurent Pla the Quant Equity GURU and the Quant Equity Income strategies at BNP Paribas. In their fund format, several were ranked 5 stars by Morningstar, belonged to the best 5% performers over 3/5 years and accounted for over 4 billion euros in asset under management (2015). Before joining BNP Paribas, Guillaume was Head of Long/Short Equity trading at Société Générale Securities. Along his 16-year career, Guillaume's work has been centered on trading and design of numerous investement strategies, first on Equity Arbitrage, before focusing on long term systematic methodologies such as "Smart-Beta" or "Risk-Premia".Guillaume graduated from ESLSCA Business School (Paris) in Finance & Trading, and from the University of Nancy in Business Law and Economics.

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About Laurent Pla

Prior to cofounding VIA AM, he co-created and co-managed with Guillaume Dolisi the Quant Equity GURU and the Quant Equity Income strategies at BNP Paribas. In their fund format, several were ranked 5 stars by Morningstar, belonged to the best 5% performers over 3/5 years and accounted for over 4 billion euros in AuM (2015). Laurent also held Head of Quantitative Research positions at Société Générale and Credit Agricole Cheuvreux. Along his 18-year career, part of Laurent's work has been centered on designing, back testing and validating multiple successful proprietary strategies. At BNP Paribas, he focused on "Smart-beta" stock selection investment strategies globally, with both a high-conviction and an income-orientated bias. During his previous experiences, Laurent's research covered the fields of statistical arbitrage, risk modelling and benchmark replication, among others. Laurent graduated from the Ecole Nationale de la Statistique et de l'Administration Economique (ENSAE Paris) in Statistics, Probabilities and Financial mathematics.

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