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Routes to Outperformance Revisited: Consistent Performance in A Game of Extremes

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To achieve superior results in investing you have to be willing to act differently to the crowd. Arithmetic and common sense dictate that if you want to outperform the average, you must depart from consensus behaviour. The great David Swensen, who ran Yale University's endowment from 1985 until his death in 2021, famously endorsed **'uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom.'** It is rational that the investment community would take this formula for outperformance to its logical extreme; because outsized returns in the recent past have come from taking outsized risk, 'uncomfortably idiosyncratic' investing has become synonymous with a concentrated approach focused on disruptive, early-stage technologies and narrative-based business models. The FT has coined this style 'moonshot investing'.[1]

On the other hand, there is perhaps underappreciated wisdom in the inverse of this 'game of extremes'. **Settling for little better than average returns for *above average* time periods is another, less obvious route to outperformance.** Although this approach is less exciting, we question whether it is the more achievable result for the majority of investors, both professional and amateur. While finding the next Amazon, Tesla, or Netflix consumes the attention of the vast majority of today's investors, hitting singles and doubles consistently can also lead to top percentile outcomes. It is a contrast in styles between only attempting winners and avoiding mistakes.

Daring to Be Different

"Everybody is identical in their secret unspoken belief that way deep down they are different from everyone else."

David Foster Wallace

The investor Howard Marks has two ways of thinking about investing performance that at first glance appear to contradict each other.

Number 1: "The real question is whether you dare to do the things necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results,

[1] https://www.ft.com/content/bce2ef2a-77d8-485e-ba69-92579f8fceb6

you have to be open to being both…Only if your behaviour is unconventional is your performance likely to be unconventional. "[2]

Number 2: "I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year…is more likely to work. The best foundation for above-average long-term performance is an absence of disasters."[3]

We think those statements feel contradictory because 'daring to be different' is now the mantra of those pursuing an investing style that *does* aim for top-decile years every year. For this group, aiming for consistent performance is a drag on the returns they can generate by instead focusing on '**the possibility of extreme upside, not the crippling fear of capped downside.'**[4] It is not the goal of these visionary investors in tomorrow's superstar companies to 'do a little better than average every year.' **There has been a mindset shift away from the probability of being correct towards the magnitude of returns if one is correct.**

The current popularity of this moonshot strategy makes a lot of sense: it is grounded in academic theory, it is exceptionally marketable, recent returns (until 2022) have been outstanding, investor flows and attention have been almost solely focused on the approach, and, because it is typically grounded in a vision about technological revolution, it appeals to the human preference for narratives. We wrote in December last year:

"The wider market had already worked out that stock market returns are typically driven by a handful of extreme winners. **In the recent past, these have been Tech companies that came public with zero profits but huge TAMs, and which have tweaked and pivoted their business models over time to now enjoy monopolistic positions in winner-take-all industries**. In hindsight, you could have paid any price for these companies, held on through any conceivable drawdown (Amazon was down -95% at one point), and still made incredible returns. Needless to say, combined with the human preference for low probability but enormous payoffs, this has resulted in the majority of fast-growing Tech companies today being given the benefit of the doubt that they will become one of those mega winners."

And recent academic theory has endorsed spotting these superstar companies early as the route to outperformance. **Hendrik Bessembinder claims that only 4% of companies outperform Treasuries over time[5] - supporting concentration and emphasising the need for multi-decade time horizons - while Michael Mauboussin found that unprofitable companies outperformed profitable ones between 1996 and 2017.**[6] Mauboussin also suggests that companies with high levels of intangible investments (like Software and other Technology-based platform businesses) often grow faster, and have greater potential economies of scale, than base rates or analysts can possibly anticipate.[7]

To active investors especially susceptible to overconfidence and recency bias, this research combined with the outsized returns to a narrow group of Tech companies over the past decade has presented an irresistible challenge. Here we have a new breed of corporate superstar that can grow ad infinitum, but which can appear unprofitable (at least as measured by generally accepted accounting principles) for similar periods. Only the most visionary and far-sighted investors can spot which ones will succeed ahead of time. It is ironic that this has led investors to all be 'daringly different' in the same way - by lengthening time horizons, increasing concentration, and betting on early-stage growth stocks.

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[2] https://www.oaktreecapital.com/docs/default-source/memos/2014-04-08-dare-to-be-great-ii.pdf

[3] https://www.oaktreecapital.com/docs/default-source/memos/1990-10-12-the-route-to-performance.pdf?sfvrsn=33bc0f65_2

[4] https://www.bailliegifford.com/en/usa/professional-investor/insights/ic-article/2021-q1-why-most-things-believed-about-investing-are-wrong-all-ar-0172/

[5] http://csinvesting.org/wp-content/uploads/2017/05/Bessembinder-Do-Stocks-Outperform-Treasury-Bills.pdf

[6] https://www.morganstanley.com/im/publication/insights/articles/article_goodlossesbadlosses.pdf?1659373263783

[7] https://www.morganstanley.com/im/publication/insights/articles/article_theimpactofintangiblesonbaserates.pdf

Of course, 2022 has proven that there are downsides to the approach, too. But the most impressive thing about this style of investing is the resilience of the marketing message for professional money managers. Having longer-term time horizons than the market, unwavering conviction in your approach, and referencing the large, prolonged drawdowns of companies like Microsoft, Tesla, and Amazon to justify periods of underperformance are all investor letter favourites.[8] It is impossible for sceptics to disprove that being patient or doubling down won't lead to 'once-in-a-generation' type returns. And while valuations are never mentioned when times are good, when times are bad it is apparently illogical not to take advantage of bargain prices for high-growth concept stocks. That message continues to resonate with institutional and retail investors alike: **Bloomberg reported in May that Tiger Global's hedge fund has seen five times more inflows than the amount of redemption requests in 2022 despite a 52% year-to-date loss betting on technology companies, while ARKK, an actively managed ETF investing in disruptive innovation stocks, has seen net inflows this year despite a peak-to-trough 17-month drawdown of -70%.**[9]

The Benefits of Consistency

In contrast, consistent performance as championed by Marks is by its very nature unglamourous. Focusing on avoiding drawdowns and losing years means being diversified rather than concentrated. Businesses that make money and which are mispriced are rarely revolutionising or 'democratising' anything. This is an investing approach missing a narrative.

But the numbers of active management (in public markets at least) contain a curious narrative themselves. When Marks made his comment (in 1992) about the unlikeliness of a string of top-decile years leading to outperformance, he was referencing a mid-Western pension fund manager who had told him that over a 14-year period: **"We have never had a year below the 47th percentile over that period or, until 1990, above the 27th percentile. As a result, we are in the fourth percentile for the fourteen-year period as a whole."**[10]

And this wasn't a quirk in the numbers before investors figured out that finding superstar companies is the only thing that matters in investing. We looked at the Morningstar data for US Large Cap 'Core' managers in 2022 to assess whether similar conditions exist today (i.e., that just being slightly above average for long periods leads to outstanding results).[11] Here is what we found (all data as of end of June 2022):

- **Of the 286 funds in the category with a 10-year track record, only slightly more than the top 10% (30) outperformed the S&P 500.**
- **3% of funds managed to outperform the benchmark while taking less risk.**
- **Median annualized outperformance for the top decile of managers was 45 basis points.**
- **In the top decile of managers, 3 funds had never had a calendar year in the top decile or in the bottom quartile.**
- **The best performing fund in the category only achieved top decile performance in 3 calendar years and their median calendar year result was in the 49th percentile.**

Most notably, none of the funds that appeared in the top decile had performance that swung between great years and awful years. While the top-performing funds were more volatile on aggregate, the median standard deviation for top-decile performers was 14.1% vs. 13.7% for the S&P 500. This was maybe to be expected but it is worth repeating: **to be an elite, top tier investor over a 10-year time horizon - with all the status, accolades, and billions of dollars in AUM that come with such performance - one had to beat the market average by about 45 basis points.** We appreciate how difficult that is by the way, but it is antithetical to the philosophy of today's investors with sky-high return expectations and risk-seeking attitudes. Consistency in this context is not about beating your benchmark and peers every single year or

[8] https://on.ft.com/3BFAg5q

[9] https://markets.businessinsider.com/news/etf/ark-invest-billion-net-inflows-despite-price-decline-cathie-wood-2022-5

[10] https://www.oaktreecapital.com/docs/default-source/memos/1990-10-12-the-route-to-performance.pdf?sfvrsn=33bc0f65_2

[11] We used the Large Cap Core category as we thought it would be the largest, most robust sample with the longest history.

by double-digit percentage amounts, it is surviving for long time periods by avoiding blow-ups and disastrous short-term results.

Focusing on Investor Outcomes

It is probably clear by now that we think the natural equilibrium between investors striving for spectacular returns and those attempting to perform consistently better than average has been compromised in recent years. An underlying theme in our notes for a while now has been the importance of diversity of opinions in financial markets. In April we wrote, **"If every investor is looking for the same thing, or trading the same way, returns are no longer driven by fundamentals but by crowding into the same positions and the pace and intensity of flows. Prices get out of whack, the fragility of the market increases, and there is an unstable imbalance."**

With this in mind, two anecdotes from a podcast we listened to in July with Dan McMurtrie, a portfolio manager at the hedge fund Tyro Partners, stood out. Firstly, he recalled the pressure he had received from investors to change his investment style: **"in the last few years it has appeared that just taking highly concentrated beta risk was the best approach. We had people come to us and say, "Shut your funds down and start a new fund and just own four stocks. And just never sell them for 10 years and we'll all make a ton of money."** Secondly, he spoke about conversations with prospective investors: **"When we talk to allocators about the stocks that we like the joke we have is we go, 'These stocks are mispriced and present an opportunity precisely because you cannot raise money on these stories. These are not changing the world. These are just businesses that make money that are mispriced, that will go up over time.'"**

When those conditions are in place, we think it is worth considering the virtues of what is being ignored rather than what is popular. In this case, that is investment styles that aim for consistent returns instead of hitting home runs. **It is an inconvenient truth that being differentiated over the long-run can also be indistinguishable from appearing average in the short-run.** That isn't a sexy narrative, but it is a narrative. **Remember that the top performing US large cap 'core' mutual fund over the past 10-years had a median calendar year performance in the 49th percentile of its peer group.** Achieving consistently average results is uninspiring, but there are surprising advantages for investors. Bill Ackman uses a formula to assess potential investments which he calls 'return-on-invested-brain-damage'. Consistent returns improve investor outcomes by reducing the denominator in that formula, while the moonshot investor likely ends up experiencing the opposite effect. For example, an investor focused on consistency:

- **Avoids the temptation of trying to time markets or pick the years which will have 1st percentile results rather than 100th.**
- **Avoids the emotional stress and opportunity costs of holding poorly performing investments through long and painful drawdowns.**
- **Avoids paying big performance fees that erode returns in the good years and which are not paid back in the bad years.**
- **Is more likely to hold the investment for time-periods which are conducive to exceptional results.**

As much as we see the logic in embracing volatility to capture differentiated long-term performance, investors are only human and will always try to optimise those returns with timing decisions that will inevitably lead to worse outcomes. The ARKK ETF is a good example – money weighted returns for investors in the fund are estimated to be deeply negative.[12] The majority of shareholders invested in ARKK after it returned 152% in 2020, so have likely experienced a -23.4% return in 2021 and -50.4% so far in 2022.[13] Over 5-years as of 31st July 2022, ARKK had returned 10.46% vs. it's Morningstar category index of 11.87%.[14] It has had two 1st percentile (best in category) performance years and two 100th percentile (worst

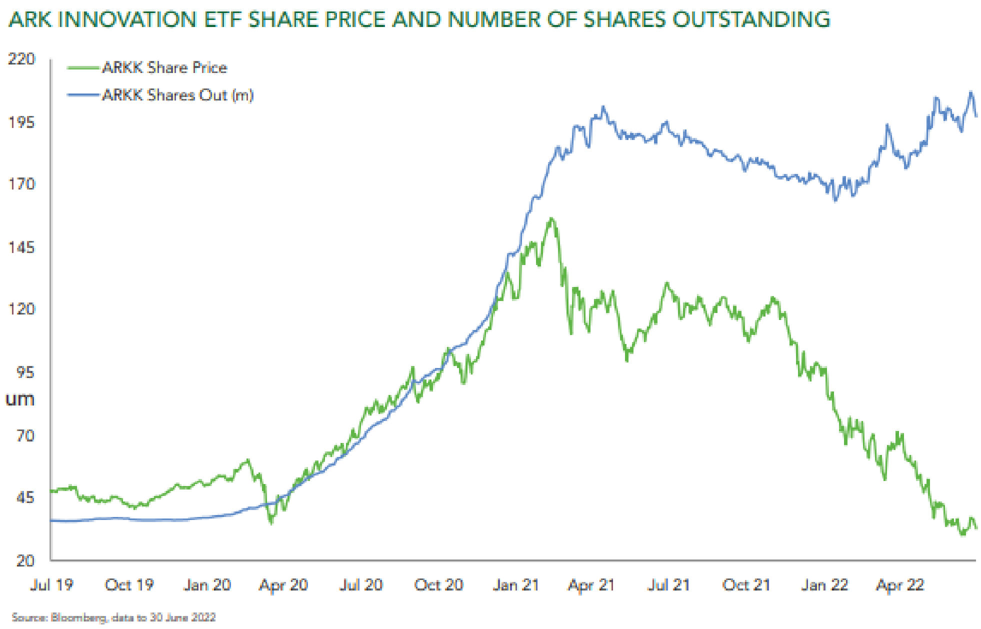
[12] https://www.morningstar.com/articles/1066496/ark-innovation-has-likely-been-a-disappointment-for-most-investors

[13] As of 2nd August 2022.

[14] https://www.morningstar.com/etfs/arcx/arkk/performance

in category) performance years in the eight years since its inception. **From a returns perspective, the difference between ARKK and the index is less than -1.5%, but it achieved those returns with more than twice the volatility and a max drawdown two and a half times as large.** For investors it has been a long, interesting trip to worse than average returns (at best) or a massive destruction of capital (at worst).

Howard Marks warned in 1992 that **"…bold steps taken in pursuit of great performance can just as easily be wrong as right. Even worse, a combination of far above-average and far below-average years can lead to a long-term record which is characterised by volatility and mediocrity."**[15] For all ARK's marketing about being on 'the right side of change' it is hard to argue that shareholders have yet benefited from investing in the future via disruptive innovation stocks. **2022's investor is learning a lesson that has been taught repeatedly over time – just because those that outperformed took on extra risk does not mean taking on extra risk leads to outperformance.**



Source: Ruffer

Conclusion

"Two roads diverged in a wood, and I—I took the one less travelled by, And that has made all the difference."

Robert Frost

In his 2021 letter, Seth Klarman of the hedge fund Baupost wrote:

"Today, aggressive risk-taking seems to many like the only sane thing to do; risk aversion may actually appear to some to be the more dangerous path, especially in terms of career risk for the money manager. We have read an increasing number of stories about institutional investors actively seeking to add risk to their portfolios, apparently from the perspective that higher risk must inexorably lead to higher returns."

We think the unwind from these extreme conditions will present opportunities for investors willing to reject FOMO in this 'exponential age' and accept that there are other ways to achieve market beating performance. While it is of course tempting to try to invest only in the tiny proportion of companies that end up outperforming over time, it is first worth asking whether it is possible to: i) pick these investments ex-ante;

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[15] https://www.oaktreecapital.com/docs/default-source/memos/1990-10-12-the-route-to-performance.pdf?sfvrsn=33bc0f65_2

ii) buy them at prices optimal for forward returns when a plethora of highly skilled, motivated investors are attempting to do the same thing and institutional flows are focused almost exclusively on the space; and iii) capture the return potential of these businesses without the accompanying volatility, drawdowns, and blow-ups that ultimately result in worse-than-average investor outcomes.

One final Howard Marks quote helps prove our concluding point, **"Bucking the trend does not have to be synonymous with taking a lot of investment risk. In fact, it is following the crowd that is risky, since the crowd's actions take security prices to such extremes."** Today, we would argue it is not differentiated to embrace risk and lengthen one's time horizons. The crowd has already taken the prices of investments that benefit from risk-seeking capital and long duration to extremes. Instead, investors could achieve better outcomes by internalising advice from Charlie Munger and Warren Buffett. **Buffett attributes his success to the fact that 'nobody wants to get rich slow' and Munger has said the key to a happy life is lowering ones expectations. We think the best foundations for investment success follow the same logic – lowering expectations helps avoid the poor outcomes usually associated with taking on risk to chase returns, while being patient and content with consistent performance allows compounding mathematics to do its thing.** This is the more likely route to outperformance for the majority of investors.

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