You Can Teach a Macro Thinker New Tricks

Predicting the impact of macro factors is one of investing's greatest temptations. Turn on the news and topics like commodity prices, interest rates, and currencies are being discussed constantly, with pundit after pundit confidently offering commentary on how these factors are going to impact equity markets. And in the short term, sometimes they get it right. When Hurricane Harvey hit Texas and it became clear that major production and refinery operations were going to be disrupted, many observers correctly remarked that oil prices would rise in the midst of the supply tightening, and companies that benefit from rising oil prices would reap the reward in the form of higher equity prices. While these types of equities would've been short-term winners, it's important to note that this is a trade, not an investment, and trading strategies rarely compound capital over long periods of time.

The term "macro" itself should imply the sheer size of the challenge, and while a precious few have been able to outperform by actively incorporating macro thinking into their process, most have been humbled into mediocrity by macro's traditionally uncooperative nature. A commodity like oil is produced and consumed across the globe, and its price is subject to countless variables, all of which are conspiring against investors intent on predicting the direction, magnitude, and impact of the price movements. Other macro factors exhibit the same qualities and predictive challenges, but this doesn't stop investors from trying (and failing) to divine their impact. If the trail of investor carcasses is not convincing enough to avoid the temptation of actively incorporating macro thinking into the investment process, perhaps investors will trust the story of one of the foremost and influential macro thinkers of our time, a man who experienced these difficulties firsthand. This individual, the celebrated macroeconomist John Maynard Keynes, discovered the hard way that company-specific fundamentals are the key drivers of investment returns, and that trusting one's interpretation of the interplay of macro factors on equity prices is not the way to earn above-market returns.

John Maynard Keynes, the Investor

Most people are aware of the legacy that John Maynard Keynes developed as one of the foremost macroeconomists of our time, but few are aware of his history as an investor. Well before Keynes published his seminal work on macroeconomics, "General Theory," in 1936, he was the Bursar of King's College, Cambridge, responsible for investing the College's endowment. As one of the leading economic thinkers in the UK at the time, Keynes believed that his insight into, and his role in, setting economic policy would give him an advantage as an investor, and so when Keynes initially received discretion over the King's College endowment in 1921, he managed the capital in a strategic macro investment style. Keynes would use monetary and economic indicators to trade between equities, fixed income, and cash, a can't-miss strategy from one of the UK's most gifted economic minds. However, as chronicled in "Keynes the Stock Market Investor," by David Chambers and Elroy Dimson, we know that the application of these factors produced a stream of consistently uninspired performances.

For nine years Keynes invested in this way, and Chambers and Dimson estimate that by 1930 the endowment was a cumulative 12.6% behind the equally-weighted equity benchmark[1] and trailed it by 40.3% over the previous five years. Keynes was objectively self-critical about the shortfall, stating in subsequent writings, "We have not proved able to take much advantage of a general systematic movement out of and into ordinary shares as a whole at different phases of the trade cycle."[2] In other words, the macro factors he was using to guide decision-making in the portfolio were not producing the results that he expected.

The intellectual curiosity and open-mindedness that served him well in developing economic theories undoubtedly impacted his approach to managing money. Keynes could see clear as day that what he was doing wasn't working, and so as Keynes the investor

[1] The equally-weighted 100 Share UK index, is representative of the sectoral composition of the broad market. Calculated by Dimson, Marsh and Staunton DMS 2002.
[2] Collective Writings of Keynes XII: 106

struggled, his investment philosophy began to transform. In a 1934 letter, Keynes wrote, "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes."[3] It took a while, but Keynes was becoming a fundamental stock-picker.

By the time that letter was written, Keynes had concentrated the endowment's portfolio into a few core holdings, a revised investment approach resulting in the King's College endowment building long-term positions in a handful of favored companies, including Union Corporation, Hector Whaling, and Austin Motors. Through this maturation process, Keynes had discovered the power that a handful of long-term winners can have on a portfolio. The impact that this shift had on the endowment's performance cannot be understated. Despite the poor early returns, Chambers and Dimson calculate that during the entirety of Keynes time as Bursar of the King's College endowment, the portfolio averaged a 16.0% return, compared to 10.4% for the equally-weighted UK equity market index.

The Impact of Long-Term Outperformers

Through his maturation as an investor, Keynes discovered the impact that identifying and holding a long-term winner can have on a portfolio's performance. A recent paper by Professor Hendrik Bessembinder from the W.P. Carey School of Business took a closer look at the underlying performance of the stock market and uncovered in relation to the market as a whole what Keynes had discovered on a portfolio level. In his paper "Do Stocks Outperform Treasury Bills?" Professor Bessembinder and his team calculated a measure of total wealth creation by all 25,782 stocks that appeared in the Center for Research in Security Prices (CRSP) database between 1926 and 2015. The paper estimates

[3] Collective Writings of Keynes XII: 57

that since 1926, the stock market has created $31.8 trillion[4] in total wealth for investors through December 2015. This staggering level of wealth creation is not surprising given the overall strength and growth of the stock market since the 1920s, although the paper takes a surprising turn when it looks more closely at the performance of the average stock. While the stock market as a whole has exhibited excellent performance, the average stock has not. In fact, only 42% of all common stocks have holding-period returns that exceed the holding-period returns of a one-month treasury bill over the same time period. If the average stock is a poor investment, Professor Bessembinder's paper asks, then why has the overall stock market been a long-term creator of value?

The answer is intuitive of course: the presence of extreme positive skewness in stock returns. A closer look at the great outperformers highlights the significance of their impact on total wealth creation. A stock-by-stock analysis shows that just 0.33% of all stocks account for half of total stock-market value creation, with just ten stocks[5] accounting for nearly 16% of the total value creation of the market. So, as the paper states, that leaves an investor with one of two options. The investor can either acknowledge the steep odds of picking winners and invest in index funds, or if their goal is exceptional returns, he or she can select a concentrated portfolio of stocks in which one or more names will emerge as truly outstanding, driving returns in the same way that a handful of stocks drive the performance of the broader market as described above.

For investors aiming for these kinds of returns, patience is paramount. As the saying goes, Rome wasn't built in a day, and the same can be said about delivering great performance. Not that the temptation isn't there. As many investors focus on incredible growth stories as a means of generating high returns quickly, generally in fast-growing areas like technology, they often underappreciate the value that a mature company can generate. Enduring investment success comes with time, and if that concept is called into question,

[4] Total wealth is the return generated by the stock market above the return generated by being invested in a risk free bond (1-month treasury bill)

[5] Exxon Mobil Corp, Apple Inc., General Electric, Microsoft, IBM, Altria Group, General Motors, Johnson & Johnson, Wal-Mart Stores and Procter & Gamble.

look no further than the strategy of the Oracle of Omaha to dispel any notion of doubt. To be fair, there are many Berkshire Hathaway investments that could qualify as examples here, but we've chosen to focus on one demonstrating particular resilience.

Warren Buffett & Coca Cola

The story of Buffet and his love of soft drinks has become legendary. He was known to keep his office stocked with Pepsi and drink upwards of five or more a day, but in the 1980s, Buffett became a Coke convert, not only of the signature product, but of the company as well. This ultimately led to Berkshire Hathaway investing $1.3 billion in Coca Cola over a span of a few years beginning in 1988. At the time of his initial investment, Coca Cola had been in existence for over a century and was one of the best known brands in the world. That long history didn't stop Buffet from making it a core position in the Berkshire portfolio, where it remains today, 30 years later. Amazingly, since he finished building the position, Berkshire has traded not a single share. There were neither buying dips nor selling near-term rallies. It was strictly buy-and-hold, underpinned by a belief that investing in a great company with great products and great management would produce exceptional long-term returns, and that taking advantage of the stock's ample liquidity by trading around volatility – where Berkshire had no insight – was a strategy for eroding returns, not enhancing them. He showed incredible patience in holding Coca Cola shares through both good and tough times, including the five-year period from 1997 – 2001 when Coca Cola lost value despite the S&P 500 increasing by over 60% on a cumulative basis. Buffet has ultimately been rewarded for his adherence to this approach, as the position has generated over $24 billion in total value, outpacing the S&P 500's total wealth creation during that time by over $10 billion.

Colonial's Investment Philosophy

As difficult as the exercise may be, the pursuit of exceptional investment outcomes remains our ultimate goal at Colonial. In pursuit of this goal, we have spent a lot of time thinking about the advantages of long-term investing and how we can identify like-minded investors. Taking lessons learned from the story of Keynes, Buffett, and others, we have identified the key attributes we believe typify great investors, which we use as guideposts when trying to find them among the hundreds of managers we meet each year:

- *Business Fluency*: The ability to identify, break down, and properly understand the factors that matter for a business over the next ten-plus years. These investors are not focused on traditional financial metrics or near-term valuation multiples, and will often purposefully distance themselves from the day-to-day machinations of the stock market.

- *Alignment of Interests*: Incentives need to be established that do not reward short-term gains at the potential expense of long-term goals. A manager should have constraints on how much capital they manage and should also be selective in working with like-minded (i.e., long-term) investors. The manager should be invested alongside its clients, with incentives aligned.

- *Concentration*: Identifying truly great businesses is not an easy task. Although there are firms that exist which enjoy great long-term success without the benefit of concentration, our experience has been that the odds of this occurring decrease as the number of stocks in a portfolio increases. As more stocks are added to a portfolio, the less time and effort can be committed to each one individually. Long-term investors need to put in significant time to understand a business, and when one of these rare opportunities presents itself, they need to capitalize.

- *Culture*: A culture that values learning, challenging itself, and introspection in the effort toward continual improvement is paramount, with a concurrent resilience to failure. Investing is fraught with too many unknowns for even the greatest of investors not to suffer through multiple failed investments. The key is to identify those that will learn from their failures and evolve.

- *Patience*: Often the hardest factor to judge is patience. While long-term investing appears to involve just one decision (when to buy), in reality it involves a daily decision to not sell as well. Patience cannot be taught, and this inherent ability can be exhibited by both experienced investors and those early in their career (with a long road map ahead of them).

- *Confidence*: This often goes hand and hand with patience. A successful long-term investor must be able to maintain confidence regardless of what the market and the masses are suggesting, although this confidence should not come at the expense of a thorough and honest re-examination of the core thesis behind each investment. It is not always easy to maintain a differentiated view point, but it will almost certainly be required at certain points in an investment's lifespan.

The Legacy of Keynes the Investor

While Keynes the investor remains an under-appreciated figure among most market participants, he does have one fan in particular; during a 2011 interview with Cathy Baron Tamraz, the CEO of Business Wire, Warren Buffett addressed a question about how to replicate the strategy of the world's greatest investor. Buffett, whose major influence is almost always listed solely as "The Intelligent Investor," the bible of value investing written by his mentor Benjamin Graham, chose to reference Keynes' work: "Chapter 12. Best chapter in investments ever written. In Chapter 12 of The General Theory, written in 1935 (sic), (Keynes) talks about the curse of liquidity, and how people turn what should be an advantage – it's easy to buy and sell your asset – into a huge disadvantage because they think it's important to know when to buy and sell this wonderful asset all the time... If you understand chapters 8 and 20 of The Intelligent Investor and Chapter 12 of the General Theory, you don't need to read anything else and you can turn off your TV."

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