Investment Philosophies: Introduction

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What is an investment philosophy?

- *What is it?* An investment philosophy is a coherent way of thinking about markets, how they work (and sometimes do not) and the types of mistakes that you believe consistently underlie investor behavior.
- *Investment philosophy vs. Investment strategy:* An investment strategy is much narrower. It is a way of putting into practice an investment philosophy.
- *In brief:* An investment philosophy is a set of core beliefs that you can go back to in order to generate new strategies when old ones do not work.

Ingredients of an Investment Philosophy

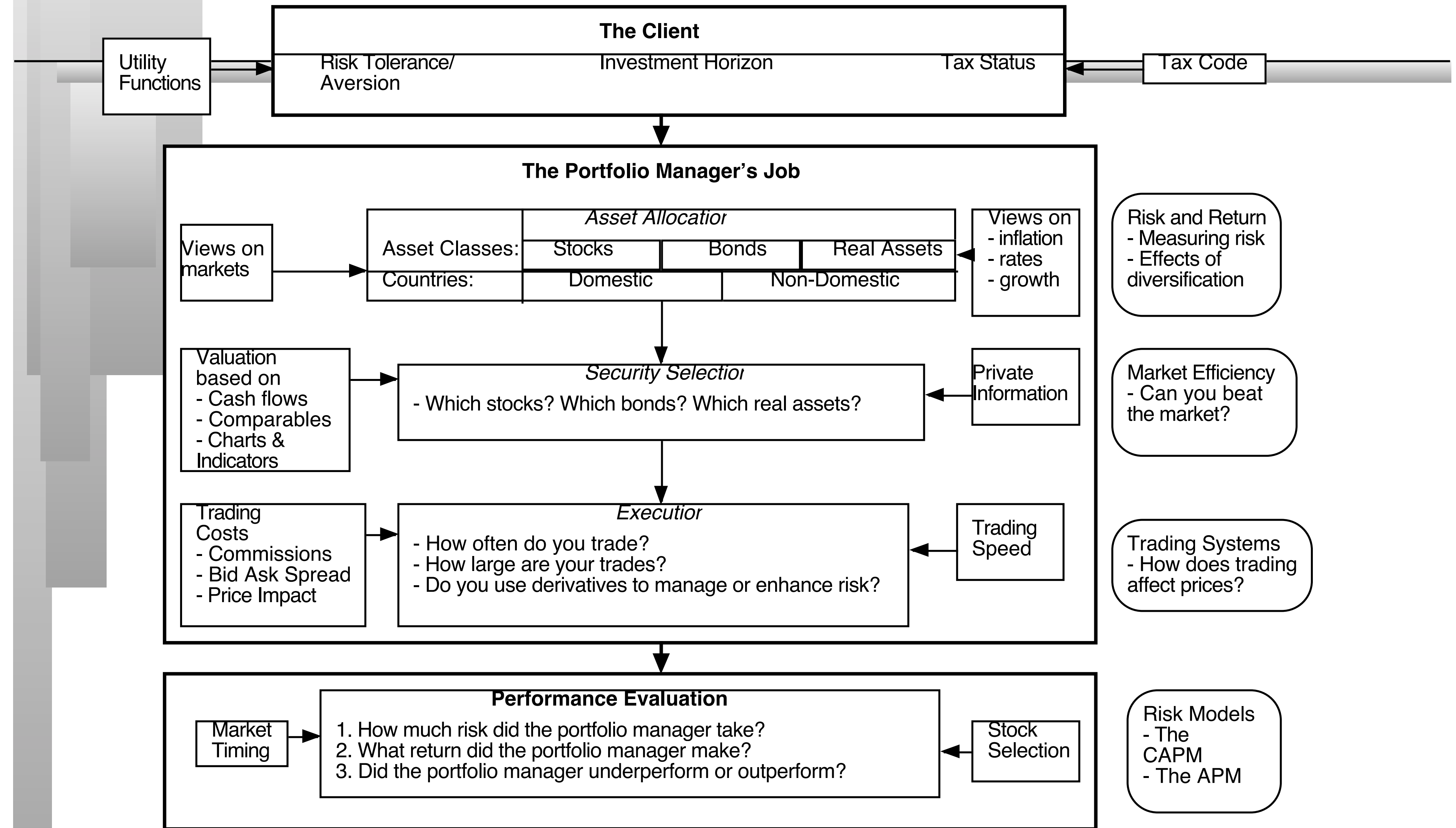
- Step 1: All investment philosophies begin with a view about how human beings learn (or fail to learn). Underlying every philosophy, therefore, is a view of human frailty - that they learn too slowly, learn too fast, tend to crowd behavior etc….
- Step 2: From step 1, you generate a view about how markets behave and perhaps where they fail…. Your views on market efficiency or inefficiency are the foundations for your investment philosophy.
- Step 3: This step is tactical. You take your views about how investors behave and markets work (or fail to work) and try to devise strategies that reflect your beliefs.

Why do you need an investment philosophy?

If you do not have an investment philosophy, you will find yourself:

1. Lacking a rudder or a core set of beliefs, you will be easy prey for charlatans and pretenders, with each one claiming to have found the magic strategy that beats the market.
2. Switching from strategy to strategy, you will have to change your portfolio, resulting in high transactions costs and you will pay more in taxes.
3. With a strategy that may not be appropriate for you, given your objectives, risk aversion and personal characteristics. In addition to having a portfolio that under performs the market, you are likely to find yourself with an ulcer or worse.

Figure 1.1: The Investment Process

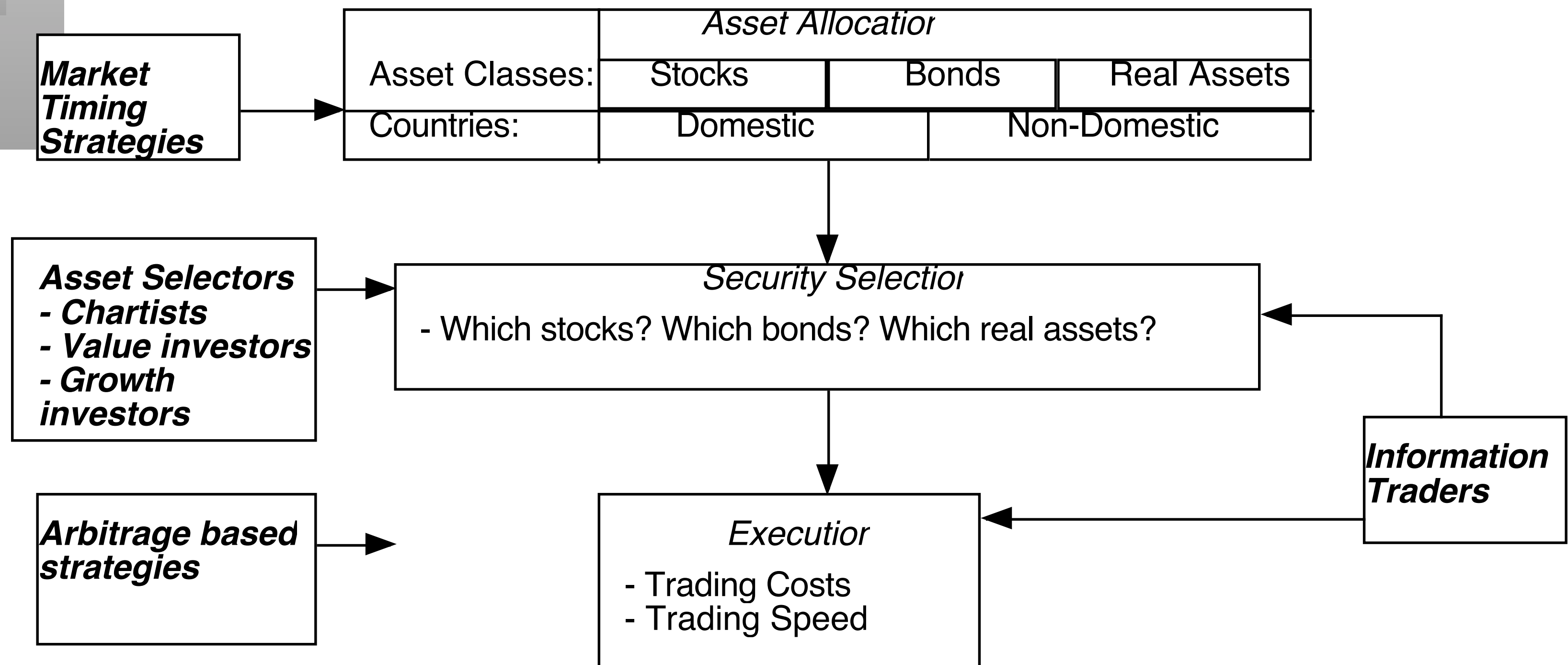


Categorizing Investment Philosophies

- *Market Timing versus Asset Selection*: With market timing, you bet on the movement of entire markets - financial as well as real assets. With asset selection, you focus on picking good investments within each market.
- *Activist Investing and Passive Investing*: With passive investing, you take positions in companies and hope that the market corrects its mistakes. With activist investing, you play a role (or provide the catalyst) in correcting market mistakes.
- *Time Horizon*: Some philosophies require that you invest for long time periods. Others are based upon short holding periods.

Investment Philosophies in Context

Figure 1.2: Investment Philosophies



Developing an Investment Philosophy

- Step 1: Acquire the tools of the trade
  - Be able to assess risk and incorporate into investment decisions
  - Understand financial statements
  - Be aware of the frictions and the costs of trading
- Step 2: Develop a point of view about how markets work and where they might break down
- Step 3: Find the philosophy that provides the best fit for you, given your
  - Risk aversion
  - Time Horizon
  - Tax Status

I. Investor Risk Preferences

- The trade off between Risk and Return
  - Most, if not all, investors are risk averse
  - To get them to take more risk, you have to offer higher expected returns
  - Conversely, if investors want higher expected returns, they have to be willing to take more risk.
- - Ways of evaluating risk
  - Most investors do not know have a quantitative measure of how much risk that they want to take
  - Traditional risk and return models tend to measure risk in terms of volatility or standard deviation

Summing Up on Risk

- Whether we measure risk in quantitative or qualitative terms, investors are risk averse.
- The degree of risk aversion will vary across investors at any point in time, and for the same investor across time (as a function of his or her age, wealth, income and health)
- **Proposition 1: The more risk averse an investor, the less of his or her portfolio should be in risky assets (such as equities).**

II. Investor Time Horizon

- An investor's time horizon reflects
  - **personal characteristics**: Some investors have the patience needed to hold investments for long time periods and others do not.
  - **need for cash**. Investors with significant cash needs in the near term have shorter time horizons than those without such needs.
- An investor's time horizon will have an influence on both the kinds of assets that investor will hold in his or her portfolio and the weights of those assets.
- **Proposition 2: The longer the time horizon of an investor, the greater the proportion of the portfolio that should be in "risky" investments (such as equities).**

III. Tax Status and Portfolio Composition

- Investors can spend only after-tax returns. Hence taxes do affect portfolio composition.
  - The portfolio that is right for an investor who pays no taxes might not be right for an investor who pays substantial taxes.
  - Moreover, the portfolio that is right for an investor on one portion of his portfolio (say, his tax-exempt pension fund) might not be right for another portion of his portfolio (such as his taxable savings)
- The effect of taxes on portfolio composition and returns is made more complicated by:
  - The different treatment of current income (dividends, coupons) and capital gains
  - The different tax rates on various portions of savings (pension versus non-pension)
  - Changing tax rates across time