An Investor Education Initiative
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Insights

5 investing insights from Jim O'Shaughnessy

Jim O'Shaughnessy is the Chairman and Chief Investment Officer of O'Shaughnessy Asset Management (OSAM). A pioneer in quantitative equity research, his interviews, tweets and writings are rich in wisdom. Here are a few insights gleaned from them that will help any investor, be it an amateur or a professional.

1 Design your own strategy

If you want to succeed as an investor, don't imitate anyone. The "Warren Buffett" of 2038 will have gotten there via a much different road. Read as much as you can. Learn all that you can. Then synthesize all that knowledge into a strategy uniquely your own, so that your investment plan reflects 'you'. When you create and own your investment strategy, you have many things in your favour. You...

- Make it easier to stick with it
- Avoid playing the victim by blaming others or events
- Commit yourself and put skin in the game
- Have the leeway to continue to study/learn and adapt as you do so

2 No one particular ratio has an advantage over a composite of ratios

A lot of people, when they think about value, they think about the P/E or the P/B ratio. Investors should go with a multiple-pronged approach to value which covers the balance sheet from top to bottom and offers a much better assessment. Move from a single ratio to many in a composite.

A decade ago, the Citibank stock looked extremely appealing because it had one of the lowest P/Es and a super high dividend yield. But on the overall value composite, it had problems and bad financial strength. This could only be revealed by examining the stock on a variety of variables: price-to-sales, EBITDA to enterprise value, price to earnings, free cash flow to enterprise value, and shareholder yield (dividend yield + buyback yield).

By considering all the various composites, one gets a much better sense for the overall attractiveness of the stock than by looking at any one specific variable. That's because there is no single factor or fundamental piece of data that is the answer or solution to the complicated question of how to pick stocks that outperform. For example, shareholder yield is a good indicator, but performs much better when selected from a group of stocks that are very cheap; have good earnings quality and have a high conviction in their buybacks, as evidenced by percentage of outstanding shares they are buying.

3 Remember that you are prone to the Recency Bias

This simply means that we recall much more easily that fact that we recently came across. This bias in behavioural finance indicates that humans put way too much emphasis on the most recent and available information, which results in us being overly pessimistic or optimistic. And as we pay the greatest attention to what has happened recently, we forecast it into the future. This translates into being drawn towards stocks where we have just read or heard something really positive and away from those where the information was negative.

At O'Shaughnessy Capital Management, a game used to be played with a 50-stock portfolio. The analysts would pick the 10 stocks that they think are going to do the best, and the 10 worst. Most often than not, the ones picked as the worst performers ended up being the best; the best potential performers performed poorly.

This is human nature; your chances of going with your gut on a stock that has great numbers could backfire.

4 Investors attempting to actively manage their portfolios need the emotional and personality traits necessary for success

Successful investing is hard, but not impossible, if you have the right traits. It is simple, but not easy.

The most difficult thing about applying your strategy is having the emotional discipline not to override it, especially when it is underperforming. Stay in your strategy and let it do its work. That is truly the hardest thing to do.

Investors (passive or active) face one real point of failure: reacting emotionally to a market selloff and liquidating their holdings, often near a market bottom. Active investors have to watch out for another factor; selling out of an active strategy that is doing worse than its benchmark, often over periods as little as three years.

Most importantly, do not fool yourself. If you lack the emotional fortitude to stick with it through thick and thin, you're probably better off not trying to do it on your own.

5 Arbitrage human nature

Markets change minute-by-minute. Human nature barely changes millennium-by-millennium. Therein lies your edge.

The price of a stock is still determined by people. As long as people let fear, greed, hope and ignorance cloud their judgment, they will continue to misprice stocks and provide opportunities to those who rigorously use simple, time-tested strategies to pick stocks. Names change. Industries change. Styles come in and out of fashion, but the underlying characteristics that identify a good or bad investment remain the same.

Each era has its own group of stocks that people flock to, usually those with the most intoxicating story: "new era" industries such as radio and movie companies (1921-1929); new technologies (1950s); the dot.coms (late 1990s); and now Bitcoin.

Far from being an anomaly, these are predictable ends to long bull markets. A long view of returns is essential because only the fullness of time uncovers basic relationships that short-term gyrations conceal.

History never repeats exactly, but the same types of events continue to occur. Investors who had taken this essential message to heart in the last speculative bubble were the ones least hurt in the aftermath. They understand that today's events and news are mostly noise, and that only longer periods of time deliver the much more accurate signal.

The same is true after devastating bear markets. Investors behave as irrationally after protracted bear markets as they do after market manias, leaving the equity markets in droves, usually at or near the market's bottom. By the time they gather enough courage to venture back into equities, a good portion of the recovery has often already happened.

We are always trying to second guess the market, but the facts are clear—there are no market timers on the Forbes 500 list of the richest people, whereas there are many, many investors.

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