

## PRACTITIONER'S POINT

### Björn Englund, manages the Dog Fund and shares his experiences on catching “falling knives” using behavioural finance insights...



#### How has behavioural finance helped you catch “falling knives” (out of favour S&P stocks)?

While the hypothesis of an efficient market is widely embraced, it fails to explain some recurring investment anomalies that do exist. These anomalies can be explained by behavioural finance theories, which concede that some other factors are at play (some irrational - some rational). As human beings we tend to behave irrationally when we experience stress, fear, when we are emotionally charged etc. We also need to rationalise and hence tend to find comfort in known, recognised behaviour patterns such as following the rule of thumb; seek loss minimisation, move in herds etc.

Instead of relying solely on an in-depth fundamental analysis when purchasing or exiting equities, behavioural patterns can be observed and explain why certain equities are overpriced darlings, while others remain under priced black untouchable sheep (so called “Dogs” - because they bark and make noise once bought) - at least for a while.

When investing in an equity, we believe a reversal to its mean value occurs - ie built-up excesses tend to level out over time. Then its stable, fundamentally realistic value (in normal terms) emerges, usually in the course of a year, and will be priced into the market.

#### Why are some behavioural patterns “tradable”, while others not? How do you differentiate and identify the former and latter?

It is one thing to prove the existence of various anomalies - (very easy for back traders and statisticians), but quite another to try to profit from the same imperfections. There needs to be a credible, underlying rational otherwise there is no guarantee that these anomalies will persist in the future. Further, if they do persist, hidden costs, transaction fees and tax effects render as virtually impossible, their conversion into pure outperformance. In addition, capital tends to flow towards market inefficiencies, which in turn, cause the anomaly to disappear over a span of time.

In our Dog Fund's investment approach we have chosen to trade on few anomalies that combine the following virtues:

- a) easily understood
- b) offer a logical rational
- c) clearly defined
- d) minimal trading costs
- e) high probability of reoccurrence

#### Don't you run the risk, that at some point, the tradable behavioural patterns might change ...?

Of course, there is always a risk of changing patterns and behaviour. However, ceteris paribus, human beings seem to change their behaviour less often than many non-human-dependant patterns and time series.

Should, for example the taxation year and/or general elections be shifted/held during the summer months (instead of the present winter months), to be followed by mutual fund reinvestments in the same period... then, yes, we would also have to change tack for timing our trades.

#### Why did you choose to apply it to falling knives and not shooting stars?

We believe investors underestimate the prospects of underperforming equities, especially for large caps that have proven themselves in the past. We also believe professional investors have a tendency to “throw out” the very worst holdings of their portfolio (emotional as opposed to an informed decision based on in-depth fundamental analysis), in order to “erase” and “hide” their misjudgements for themselves and everyone else.

#### Does it lend itself to better performance?

Yes, based on our thinking we believe this investment approach has a sounder logic base, is a longer-lasting, recurring theme and should perform better especially when viewed from a risk/reward perspective ... as opposed to buying overpriced shooting stars. In a wider context, the discussion of value vs. growth can also be applied.

#### Why do you choose to apply it to the S&P 500 stocks only?

Herding tends to be most prevalent where the herds are the largest. In the US, institutions are drawn to using an advanced benchmark like the S&P 500. This is the reason why we have not applied our thinking to, for example, Europe, where EU benchmarking is less common, and where the herds of sheep (=fund managers and traders) are fewer and also fractionalised between different regions, trading barriers and thus benchmarks. At another level, we believe, in order for behavioural finance to be an integral part of an investors' overall investment process, it must be able to face the challenges faced by the toughest markets: trading large caps on Wall Street.

#### Who should be investing in such a strategy and why? What sort of net annualised returns can they expect?

Today, more than 90% of the Dog Fund's assets under management are institutional. Among individual investors it is only the most informed that can relate to behavioural finance - we think it takes a very special kind of manager to accept that they, as a group, are adding “negative” value. We try to profit from their aggregated incompetence. For our long-only Dog Fund we expect to outperform the US market with some risk-adjusted 50% higher returns per annum over a business cycle (for example, 15% versus the market's 10%). In our long/short mandates this outperformance is dependant on the leverage applied.

#### Comments/remarks...

“The king is naked” ...