A Guy in the Attic

"Diary of a Private Investor"   Update #12   Colm Fagan   9 March 2019

An anonymous reader, writing on the website askaboutmoney.com under the pseudonym "Gordon Gekko"[1], questioned my DIY approach to investing, asking: "How can a guy on his own, working from his attic, beat the professionals?"

"Gordon" went on to tell of his friend, "a stellar stock-picker with a global investment bank (as in $10m+ bonus a year)", who had left his job and had assembled a team of specialists, aiming to beat the market. According to Gordon, lots of people lampooned his friend's efforts. Gordon then posed the question: if someone with his friend's ability and back-up team had doubters, how could I, "one man and his dog", possibly hope to do well over the long-term?

To answer Gordon's question, let's do a thought experiment. Imagine two sophisticated investors, Abigail and Beatrice. Both employ experts to help them: CFA's (Chartered Financial Analysts), quants (Quantitative Analysts), accountants, maybe even a few actuaries.

After surveying the market, Abigail and her team decide they'd like to buy shares in company X. They assemble lots of information on the company, its products and markets, the quality of its management team, etc. and eventually decide how much they're prepared to pay for the share.

Beatrice already holds shares in X and would like to reduce her holding. Maybe, like me, she's getting on in years and needs the money. She and her team get out their spreadsheets and eventually decide a price at which they'll be prepared to sell.

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[1] Post #95 on https://www.askaboutmoney.com/threads/new-sunday-times-feature-diary-of-a-private-investor.195710/page-5

Abigail and Beatrice start haggling – virtually of course, through the stock exchange - and eventually arrive at a price "P" that's acceptable to both.

Meanwhile, the guy in the attic decides that he'd like to buy a few shares in X. He toddles along to his stockbroker and puts in his order. He ends up buying at "P", which happens to be the going price, as decided by Abigail and Beatrice and their respective teams of experts. The guy in the attic knows nothing about Abigail's and Beatrice's haggling but by buying at P he has unwittingly tapped into their collective expertise –at no cost.

Twenty-three years ago, thoughts on these lines prompted me to decide to manage my own pension investments rather than entrust them to professionals to manage on my behalf. I had no experience of investing, but I trusted the market to get prices right most of the time. I reckoned that, by buying stocks at random, I wouldn't match the professionals' gross returns (i.e. I accepted that there was still some room for skill), but that the net returns from my random portfolio would be comparable to those earned by the professionals, after deducting their charges.

About eight years ago, fifteen years into my DIY investment voyage, I concluded that the market was far from efficient, that it had significant inefficiencies, but that the nature of pooled investment products (mutual funds, unit trusts, unit-linked funds) forced the managers of those funds into straitjackets that hindered their ability to exploit the inefficiencies. DIY investors could escape the straitjackets and therefore could aim higher.

A lightbulb moment came while I was attending an investment conference hosted by a major financial institution. In the course of a presentation on the institution's European Equity Fund, the Fund's manager said that 20% of the Fund's investments were in companies that he and his team had classified as winners. In the subsequent Q&A, I asked the obvious question: why wasn't the "winners" proportion 100% rather than 20%?

His – somewhat embarrassed - reply was that investors expected returns from the Fund broadly to match the relevant index (European equities in this case). This prevented the manager from straying far from the index when deciding which stocks to hold and what weightings to give them, thereby limiting the manager's ability to exploit any insights they might have on the relative merits of different stocks. DIY investors are not subject to the same constraints.

My recent experience with Phoenix Group Holdings illustrates the point. At end 2018, Phoenix represented 25% of my long portfolio. This was already a very high exposure to a single share. I believed the company was significantly undervalued so, despite my already high exposure to the stock and the fact that I was making regular withdrawals from the portfolio to meet my income needs, I still managed to increase my exposure to Phoenix. Now, just over two months later, Phoenix accounts for over 33% of my portfolio. Its share price has risen more than 23% since the start of 2019 and sterling has strengthened against the Euro (although my currency gains were limited by a decision to hedge a portion of my sterling exposure). The net result is that, in the last few months, Phoenix has made a significant positive contribution to the portfolio's performance.

Many professional fund managers would also have concluded that Phoenix Group was significantly undervalued at the end of 2018, but they would not have been able to use that insight to make a meaningful difference to the performance of their portfolios. Phoenix, with a market capitalisation of £5 billion, is a relative minnow in stock market terms, accounting for less than 0.2% of the UK market. A fund manager would be sticking their neck out – possibly to the point of putting their job at risk - by allocating even 1% of their portfolio to Phoenix Group. A weighting that low would do virtually nothing for a pooled fund's performance.

This is just one of the ways in which the DIY investor can match or even beat the professionals. There are many others, which I hope to explore in future updates. Meanwhile, I plan to continue working from my attic.