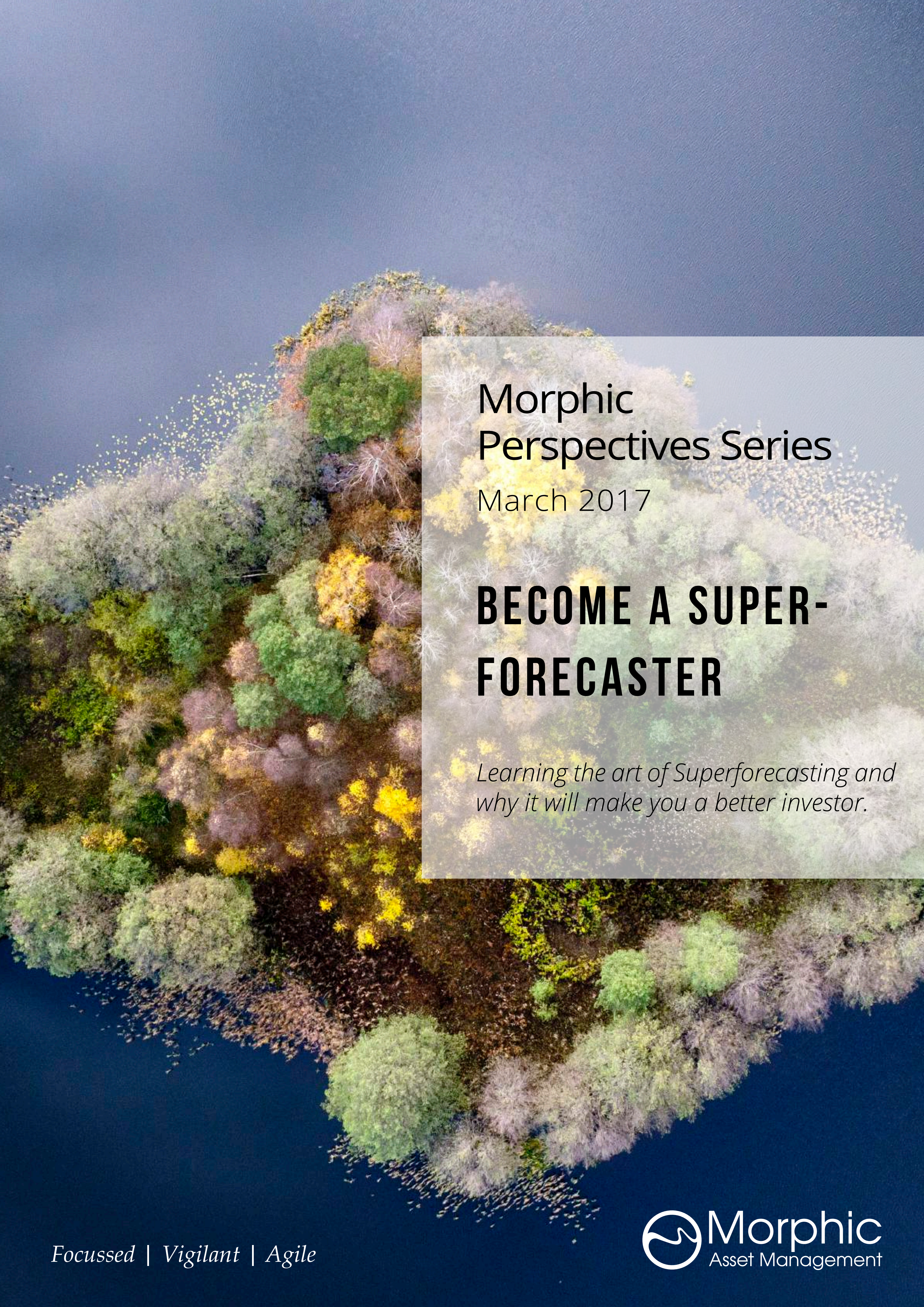


Morphic
Perspectives Series

March 2017

BECOME A SUPER-FORECASTER

Learning the art of Superforecasting and why it will make you a better investor.

Focussed | Vigilant | Agile

Morphic
Asset Management

INTRODUCTION

There is no shortage of self-help books in the world and the list of sub-genres continues to grow each year. In fact, about 6% of all books sold fall under the self-help category and Americans spend about $600m on this genre alone each year. Arguably it stems from the confluence of two human traits: humans seem to be innately optimistic and hence this appeals to the idea of being better; but they would prefer it consist of a few easy steps that takes as little time as possible.

The purpose of these Perspectives Series pieces is to provoke both our own and our readers' thoughts on new ideas (as per our pieces on the evolution of the Funds Management industry), but also to provide some level of education or assistance in areas where we have tried to work on improving our processes at Morphic.

"Changing investments at the wrong time can wipe out a lot of profit, leaving the average investor much worse off."

The idea was to provide these thoughts early in the year, so that they are akin to a New Year's resolution. Though given it's only March, my New Year's resolutions already look shaky!

This quarter's piece looks at one technique that we use internally to help improve our investing results. Though we forewarn you – it looks deceptively easy, but is harder than you think to stick to. Just like any weight loss program out there!

THE PROBLEM: WHY IS THE RETURN OF THE AVERAGE INVESTOR BELOW THE AVERAGE RETURN OF A FUND?

In January, we were reviewing the Fund numbers for 2016 year end and there looked to be an error: the percentage return for the year was higher than the dollar change in the Funds Under Management and didn't reconcile. After scratching our heads, we realised what the issue was and it wasn't an error. More money had been redeemed at the low points of the market and conversely more money had flowed in at the high points of the year. This opens up a gap between the Fund's returns (% change) and the investors' returns (dollar change).

This is actually a well-known phenomenon within funds management and quite a few academic studies have shown this holds more generally over the years. In this piece by Friesen & Sapp (2007) the authors showed that retail investors switching in and out of funds wiped out any excess return that those funds actually earnt. And just to show you that so-called "sophisticated investors" aren't immune to this behavioural problem, Dichev & Yu (2011) found the same result in hedge fund investors who are supposed to know better!

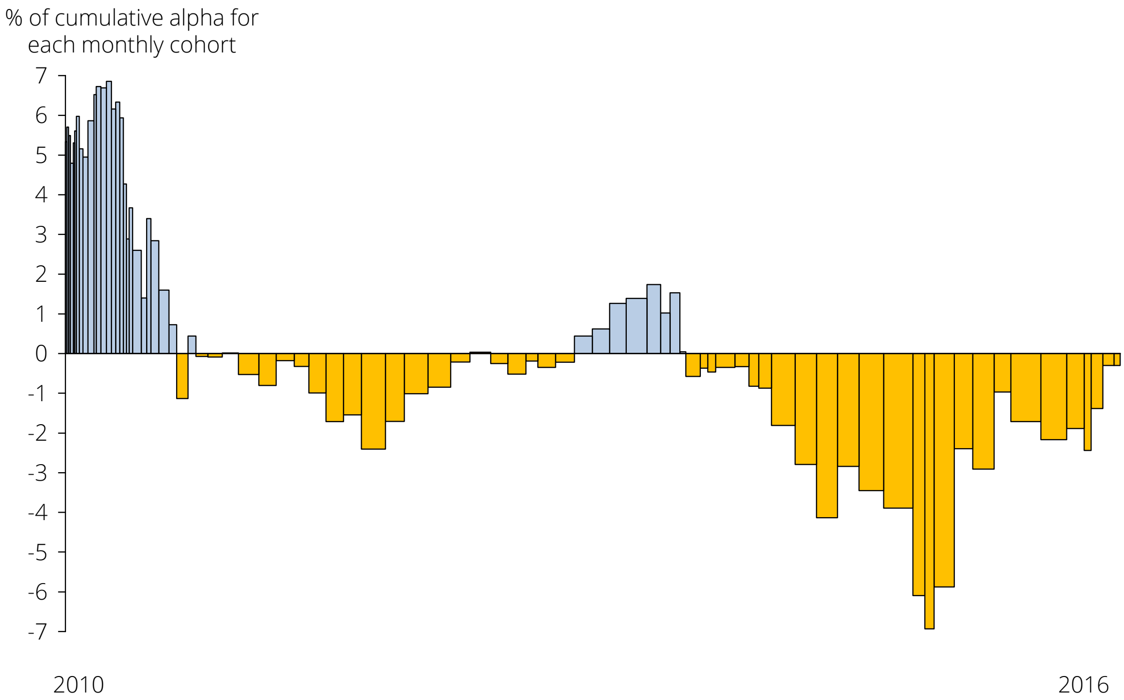
Why does this matter? Because changing investments at the wrong time, whether it be investments within a managed fund, or single stock names, can wipe out a lot of profit, leaving the average investor much worse off.

DO YOU HAVE A LOCAL EXAMPLE OF THIS?

The above analysis would suggest that, if the data holds true, then most investors (as defined by percentage of FUM) should have experienced no excess returns, particularly if the manager has experienced high returns.[1] **Figure 1** below is the return profile of alpha by cohort for an Australian Fund. The height of the column is the amount of total excess return experienced by

1. Friesen et al., 2007

Figure 1 - 75% of flows since 2010 have suffered negative alpha



Source: Australian Fund X website, Team Analysis

the investor that came into this fund in each month of each year. The width is the amount of money that flowed in.

What is clear is that the high returns early on only had small inflows, but the latter periods of underperformance was when most of the money flowed. As a result over ¾ of inflows since 2010 have negative returns, even though the fund has had very large outperformance since 2010.

BECOMING A "SUPERFORECASTER"

So how does one improve this behavior? The short answer: write a diary/journal. I can hear the collective groan - "what - is that it? A diary!" But like a lot of things in life, the simplest things are often the hardest.

If you don't believe me on it being the one tip, watch this video at the start to see Kerr Neilson giving his one big tip (we may not like the stock, but we always rated the man); or read the doyen of hedge funds giving a masterclass in real time trading of macro events from August 1985 to November 1986, via publishing his trade diary.

In fact, the documenting of your actions and more importantly, your planned actions, goes beyond finance and into other areas.

In "Superforecasting: The Art and Science of Prediction" by Philip Tetlock[2], Tetlock shows that certain "ordinary" individuals forecast events better than experts in many areas, even when they had access to less data than the experts. Tetlock was fascinated by these results and went back to each of them to see if he could find common characteristics across them. He found four traits:

1. philosophic outlook,
2. abilities and thinking style,
3. method of forecasting, and
4. work ethic.

2. A book I'd highly recommend reading for those who want to become better investors or for anyone who just wants to forecast better.

Without going into everything in detail here, the findings that were noteworthy is that these "super-forecasters" whilst being above average in intelligence, were not all in the highest IQ category; that the ability to improve forecasting could be taught; and work ethic/discipline and constant questioning of prior views were the dominant features.

It means you can vastly improve your probability of success at forecasting by using a methodology and framework that incorporates updating their predictions and odds through time.

Internally at Morphic, everyone was asked to read the book last year. Along with this, all investment proposals are encouraged to be turned into "living documents" that are updated to reflect changes in the investment thesis.

HOW DO I IMPLEMENT THIS WITH MY SUPERANNUATION OR SHARE INVESTMENTS?

Firstly, think about some price levels now, when you are not under stress. For example, consider an investment in the Morphic Fund. Ask yourself "what do I expect to achieve and what is my timeline?".

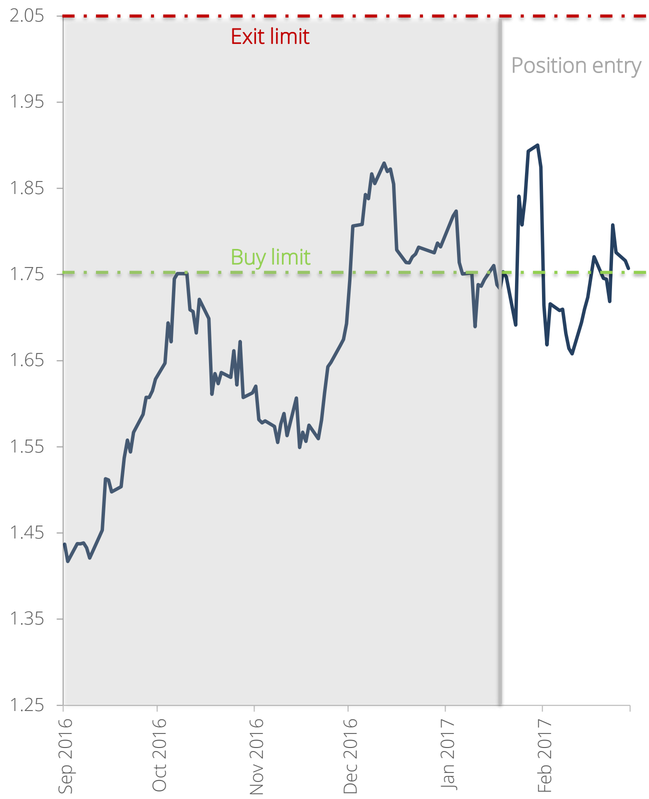
Whilst everyone will have differing answers, I personally look for "equity like returns that aim to fund my retirement". That tells me two things: how much I should expect to make or lose and how often I should reassess the outcomes.

The "expect to make or lose" number is a function of the volatility of global equities through time in Australian dollars. As a rough rule of thumb, I should expect to lose 10-20% at least every 2-3 years and 20-30% approximately every 6-8 years. So, one "level" to choose is that if my investment loses 20%, I would reassess. This may result in nothing happening, but it should be written up in a diary as to why nothing was done. "Fund retirement" means that if the levels don't happen, then only every 2-3 years should I look at it.

This "call to inaction" is important as well, because one of the other habits of good investors, be they traders or Warren Buffett, is that they don't overtrade.

If we switch to an example of buying some shares rather than a managed fund, you should be writing down the reason why you are buying these shares; what you expect to make; how much you should reasonably expect to lose and still be "right"; and how much of a loss suggests you are "wrong". These are your levels as revisit points. You identify events that will make you change your mind; and you then give a time point, say one year from today just for a fresh look, if the levels aren't hit. Below are some nominated levels from a Morphic investment in European airlines.

Figure 2 - Wizz Air vs. Easy Jet ratio



Source: Lipper, Team Analysis

In this way, you aren't pulled around by the market. You have pre-defined points of action and time points to check in. As each one gets hit, a diary entry is written. This sounds like a lot, but in table form it's relatively straight forward. **Figure 3** below is one table from the prior Morphic investment report that identifies trigger events and assigned probabilities.

Over time you will be able to see if you are assigning either:

1. the incorrect probability; or

2. the incorrect events; or

3. the incorrect confidence.

All these can be improved and calibrated, which is what the best forecasters in Superforecasters do.

HOW HARD IS IT AND HOW CAN MORPHIC HELP YOU?

Let's be clear: this is a hard habit to get into. There was a reason "work ethic" was nominated in Tetlocks list. There is always a reason not to do it and there is often a reason to change your mind beforehand. So, don't get dejected if you have trouble sticking to it at first.

Since starting Morphic I have come to appreciate better that if we can help our investors improve their overall investing, we can add a lot more to their retirement wealth. For those investors who became nervous and without a plan quit equity markets last year at low points, they have forgone large gains that any fund's alpha can't even come close to making up for when if they decide to re-enter equity markets later.[3]

So, if we can help improve your decisions for your whole portfolio, we have added substantially more than our fees to your investment returns.

Figure 3 - Worked example - Risk Tables

Downside risks

EVENT	Effect	Assigned Probability	Confidence in probability
WIZZ Summer capacity disappoints	Downgrades	40%	Medium
EURGBP strengthens	Underperformance	50%	Low
EZJ keeps LF and better pricing	EZJ upgrades	20%	Medium
Credit markets push new lease rates	WIZZ downgrades	10%	Low

Upside risks

EVENT	Effect	Assigned Probability	Confidence in probability
EZJ stuck in pricing/growth downward spiral	EZJ de-rating & downgrades	20%	Medium
EURGBP strengths (euro strength)	Upgrades	50%	Low

Source: Team Analysis

3. And this is why no investor will get even close to the Index returns of an ETF – their market timing decisions tend to destroy a lot of value.

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