# Conviction

**"The agreement or disagreement both of the sentiments and judgments of other people with our own, is, in all cases, it must be observed, of more or less importance to us, exactly in proportion as we ourselves are more or less uncertain about the propriety of our own sentiments, about the accuracy of our own judgments."** - Adam Smith

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## The Downside of Conviction

By John Rekenthaler | 12-23-16

**Absolute Certainty**
Last week, FPA announced that veteran portfolio manager Bob Rodriguez was retiring, effective Dec. 31. As FPA noted in its press release, Rodriguez ("Bob Rod" in Morningstar's fund-analyst slang) is the only fund manager to have collected Morningstar Manager of the Year accolades for both stock and bond funds. Indeed, he won three such honors for FPA New Income (FPNIX) in 1994, 2001, and 2008. ...

The first two awards presaged seven years of good fortune, but the third was no charm. Positioned to protect against the next bond bear market, FPA New Income sharply trailed the Barclays Capital U.S. Bond Aggregate in 2009, and in 2010, and in 2011, and in 2012. It recovered to outperform in 2013, then went back to lagging. Cumulatively, it has dropped 16 percentage points to the index since its 2008 triumph.

Nobody can accuse Rodriguez of lacking conviction. Quite the contrary; he is the industry's most vocal, impassioned bond fund manager. DoubleLine's Jeff Gundlach attracts more headlines, but he leaves open the possibility of altering his tactics should the markets change. Rodriguez, in contrast, beats the same drum: The U.S. financial system is broken; bond investors live on "borrowed time"; Federal Reserve officials are "glorified snake-oil salesmen."

**That's Entertainment**
Such passion is good for business. Table pounders are quotable. Journalists like them, fund analysts like them, financial advisors like them, and investors tend to like them. They also make for excellent speakers. Rodriguez drew a standing ovation with his thunderous condemnation of all finances American at the 2009 Morningstar Investment Conference. The audience loved it. If, however, they had acted on those comments, they would so far be poorer for their efforts.

This is not to disparage conviction. If this column did that, it would deconstruct itself, as it would be insisting about the error of insisting. We all know the story of *The Big Short*--insightful investors who foresee what looms, and who must have the courage of their beliefs to withstand steep market losses before enjoying even steeper market gains. That large tale is retold in small, year after year, throughout the financial markets. Often, being right means willing to endure long stretches of being wrong.

However, there is a difference between appreciating that some investments require patience, and praising the fault of intransigence. This is not to say that Rodriguez, specifically, has been stubborn. Perhaps he has not updated his views because he *is* correct. Rather, the point is that, as a general rule, refusing to change is no better than changing. ...

**Changing for the Better**

And there are plenty of cases where abandoning conviction has served investors well. In their glory days of the '70s and '80s, when they routinely beat the S&P 500, Fidelity's diversified stock funds were famously (or notoriously, depending upon your view) flexible. Their managers would buy the securities that they liked, regardless of what the funds' names and prospectuses might imply. That spirit lives on today with giant Fidelity Contrafund (FCNTX), which, despite its title, holds so many popular stocks that Morningstar categorizes it as a large-growth fund.

Another example would be the AQR organization, which expanded from running only hedge funds for institutions and qualified investors, to running registered funds for retail investors. The new funds were passively managed rather than actively so, diffuse rather than concentrated, and priced very differently. True, AQR had business reasons for making that decision, but there's no doubt that it tossed a few convictions out the window while doing so--and that investors have profited. (Heralded value investor Joel Greenblatt took a similar step with his firm, Gotham Capital.)

In academia, efficient-markets theorist Eugene Fama not only granted that stock performances were affected by companies' sizes and price/book ratios, but also that they were influenced by stock-price momentum. In the short term, stocks that had performed well tended to continue to perform well, and vice versa. The size and price findings could be explained away as caused by those securities' higher risks. But not momentum. In the words of Morningstar's Maciej Kowara, Fama decided that just because he didn't understand the effect, didn't mean that it didn't exist.

For an academic, that does indeed amount to singing a new tune.

**The Oracle of Omaha**

The most famous and successful of flexible investment managers, of course, is Berkshire Hathaway's (BRK.A) Warren Buffett. As the '60s closed, Warren Buffett owned a smokestack company and operated a hedge fund. (Yes, he did.) During the next decade, he morphed his industrial business into something resembling an investment partnership, focusing on financials and media companies, and folded the hedge fund. In a sense, Buffett had become the leading mutual fund manager.

In that role, he has continually changed. In the '90s, Berkshire Hathaway swapped out of its dowdy media businesses and bought such glamour blue chips as Gillette and Coca-Cola (KO). Had Buffett, the value-investing legend, become a growth-stock manager? Yes and no. Those were certainly growth stocks, by any definition of the term. But Berkshire's forthcoming purchases of a railroad and energy concern were certainly not. Nor were its tactical dabblings, such as its 2008 investment in Goldman Sachs (GS).

Nietzsche wrote that convictions are greater enemies of the truth than lies. That overstates the matter--as Nietzsche was wont to do. Let us say, more humbly, that conviction in and of itself is no virtue. What matters for investment managers is being *correct*. ...

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**Our thoughts**

As Quantitative, Factor-driven investors, conviction matters a great deal. It is because Insiders typically buy when their stocks are out of favor, that Value doesn't always beat Growth, that analyst's Earnings Estimate trends often prove errant, or Small Caps don't always beat Large Caps, or Momentum isn't immune to Mean Reversion that these Factors exist. However, as Damon Runyon pointed out: **“The race is not always to the swift, nor the battle to the strong, but that's the way to bet.”**

Our primary stock selection system is detailed in a White Paper ("A Real World Study of Quest Opportunity Fund's IVE Stock Selection System") on our website. While only 55% of the stocks outperformed the Russell 2000 over the 8 year study, the average stock outperformed the index by 19.7% annualized. The IVE System was actually created in and has been successful since the early 1990s. Part of its success stems from the increased number of opportunities during corrections and bear markets. Buying when others are clamoring to sell requires conviction.

A soon to be former client back in November: "I’m much more comfortable with any pick if it has the 5* rating." He was referring to Morningstar's rating system for Funds, which is based on 3, 5 and 10-year **Performance**, with 5 stars being their highest rating. In 2014, Morningstar ran a study for the WSJ: "Only 58, or 14%, of the 403 funds that had five stars in July 2004 carried the same rating through July 2014 ...." Chasing **Performance** is one of the two surest ways to underperform the market. It takes 3 years for a Fund to be rated by Morningstar. Our clients were already in GPIIX, because of the track record of the **People** that founded Grandeur Peak and their Quantitative investment **Process,** when Morningstar acknowledged their performance with its 5* rating. By that time GPIIX was closed. As previously shared, we were already very familiar with OBIOX's Quantitative **Process** before the Fund's inception. AQR's unrated QMNIX is another example. **Process** is the foundation for sustainable **Performance**, otherwise, **"It's like somebody who plays Russian roulette three times in a row without the gun going off, and thinks they're great at Russian roulette. The fourth time, they blow their brains out.**" - Daniel Loeb, founder of $9 billion hedge fund Third Point. Understanding the academic evidence for Factor based investing is only the first step. Conviction is necessary to ride out the inevitable periods of underperformance.