Business Today

Sensible investment strategy involves ignoring noise, using a systematic criterion to pick assets: Devina Mehra

A sensible investment strategy involves ignoring the noise and using a systematic criterion to pick assets. A good investment strategy can be boring.

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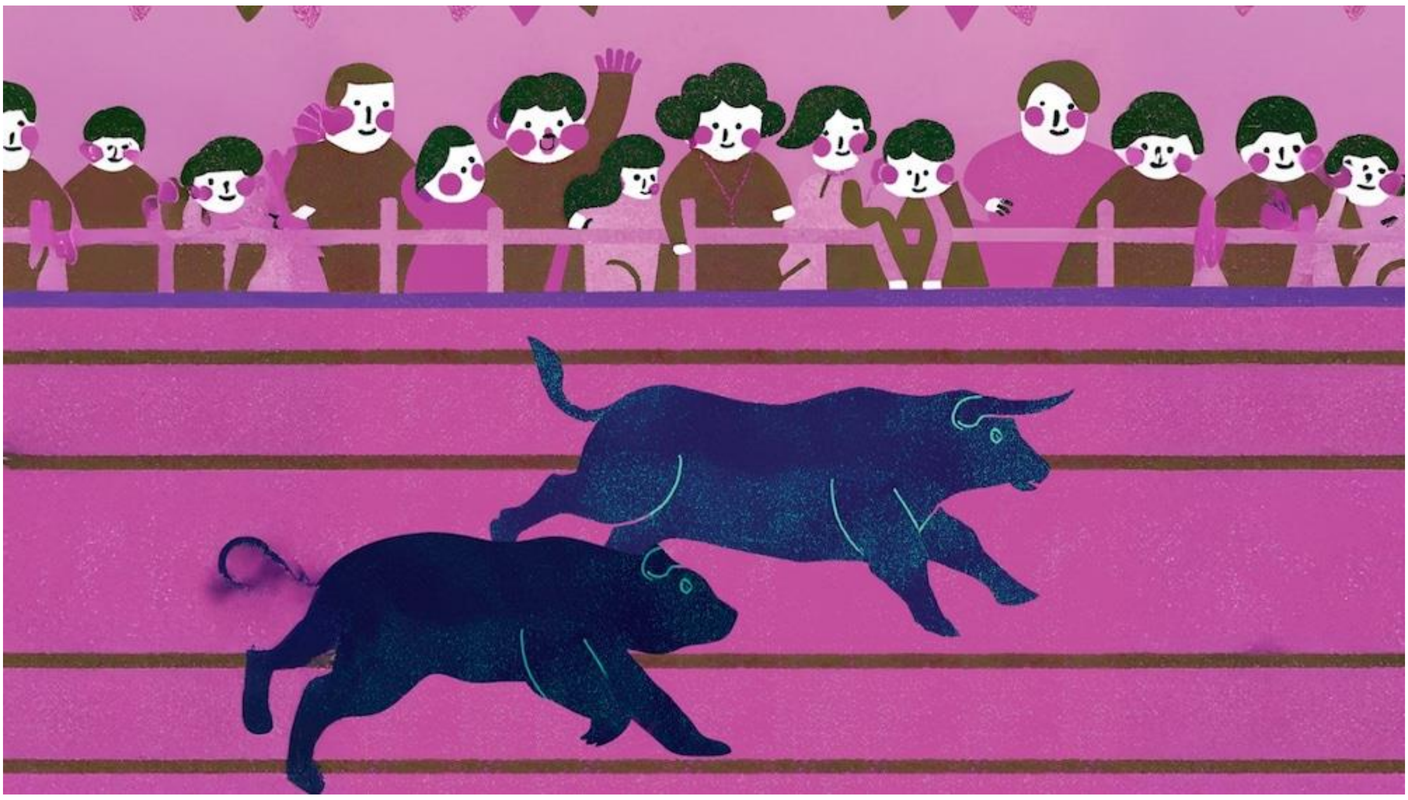

No Theme Lasts Forever

When I'm asked in interviews on how to identify areas of excesses or froth in the market, I half flippantly say that the easiest way to do this is to look at areas or themes where thematic new fund offerings (NFOs) are being launched.

In the last 18 months, some of the popular themes for NFO launches have been defence, PSUs, industrials, small-cap, etc. Most of these haven't performed well since their launch, and this is not an aberration.

Data studied by First Global shows that thematic funds almost always tend to be launched near the peak of that theme. Even going back over the years, many technology funds, for example, were launched just before the 2000 stock market crash!

More recently, in 2021, many Nasdaq or China/Greater China funds were launched. All of them crashed in the following year, with the Nasdaq almost becoming the worst performing global index for 2022.

This is a theme (pun intended) you would see playing out every time NFOs come around a particular category, whether that category is a geography, a sector, or size (small-cap vs large-cap). Usually, investors lose money or underperform on such investments.

Devina Mehra, Chairperson, Managing Director & Founder of First Global

The truth is that fund houses also know that risks are high and super-normal returns are unlikely in these themes.

But they also understand that this is when lay investors have come to know about that theme. Most have some FOMO (fear of missing out) and, hence, when the scheme is launched, they participate enthusiastically. That may not end well for the investor but bring good tidings to the asset management company, which is able to gather assets and earn fees on the new schemes. All these play on the trend-following instincts of human beings. And this plays out not just in the markets, but everywhere.

Think about why you want to buy a Tumi bag or the latest iPhone model. After all, the functional use can be met by something that costs a tiny fraction of the price. Interestingly, this desire to possess a branded bag or phone goes back to a time when there was no marketplace at all!

It is a hangover from our hunter-gatherer days when human beings lived in caves. The common theme is that we want to belong—belong to our tribe, whatever that tribe may be. Whether it is the 'in' crowd in college, the 'suits in the corporate world or the studied 'grunge' of the tech start-ups, we want to be like the rest of the tribe.

Why is this herd instinct so very strong? Simply because not so long ago in human history, if you did not belong, you were history!

Human evolution has optimised our brain for survival and procreation. And if any human being went out of the tribe, he or she could not procreate for sure, and may not have been able to survive either.

We are the progeny of ancestors who continued to 'belong' and that remains hardwired into us humans—whatever we define as our tribe. That is why it is very uncomfortable to not fit in, and that is the core of the FOMO feeling.

Unfortunately, this wiring of the brain is not great for our investment portfolios.

The key in the market is understanding that no theme lasts forever. No country. No geography. No asset class. And within a country, no sectoral theme or even investment strategy (say, value vs growth). In fact, it can be mathematically proven that entering themes or strategies that have done well of late will systematically cause your portfolio to underperform.

Does that mean that you should always go against the trend? Not quite, because both positive and negative moves can last for a while.

Companies or industries can go through prolonged periods of doing well or otherwise.

The problem also is that human beings hold on to stories or narratives; so, if something is classified as a good company or a good theme, we tend to hold on to that even when facts change, either in terms of fundamentals or extreme valuations.

Similarly, when an area has been classified as a dog, most fund managers will not look at it even when the fundamentals change. That's where a systematic approach works.

For example, our artificial intelligence systems had flagged the turnaround in capital goods in October 2021 and we went overweight on the sector. Most human fund managers took another two years to realise that the fundamentals had changed for the sector, because in their minds it was a dog sector, as it had been for 12 long years.

In short, a sensible investment strategy involves ignoring all the noise in the outside world and using a systematic criterion to pick assets and stocks for your portfolio. A good investment strategy can be boring.

The author is Devina Mehra, Chairperson, Managing Director & Founder of First Global, and Author of 'Money, Myths, and Mantras: The Ultimate Investment Guide'. Views are personal