P E R S P E C T I V E

Cognitive Dissonance

April 1, 2024

Here are a few things I would've thought were hard for investors to believe simultaneously. I would've been wrong…

1) International diversification stinks for U.S. investors…
…but is fantastic for non-U.S. investors in perpetuity, as the U.S. will always win (here, here).

2) Not owning the bad companies (however you define ESG) is making the world a better place…
…but shorting them doesn't work even better (here, here).

3) Investing in privates makes us more patient, better investors because, even though we know prices are changing constantly, we don't have to see or acknowledge them change…
…but even after we say that quiet part out loud, this self-deception somehow still works for us (here, here). [1]

4) Illiquidity is a "bug" that investors in private assets should get a return premium for bearing, as you get paid for putting up with a "bug"…
…but illiquidity is also something that makes private assets easier to hold (a "feature"), and that benefit should be free and not impair the premium at all because you never pay (in lower expected returns) for a "feature" (here).

5) We believe in stocks for the long run, and we know they will have terrible drawdowns that we must stoically bear to earn their return premium…
…but if an uncorrelated alternative has a terrible period—even if you can directly point to its epic cheapness—we get out, as patience doesn't apply here as it does with stocks (here).

6) The point of those uncorrelated alternatives is to make money over the long term while being, you know, uncorrelated…
…but we still evaluate these investments by comparing them to stock market returns, feeling extra good about them when the stock market is down, and extra bad when the stock market is up (here).

7) We believe we have found skillful active managers whose long-only stock picks will outperform the average…
…but if we relax the no-shorting constraint, they won't do a single drop better as skill is rewarded only for the long side of a portfolio (here, here, here).[2]

8) We understand the victory for the U.S. stock market over ex-U.S. markets over the last 30-ish years has come mostly from re-valuation (the market going from paying less for U.S. cash-flows to paying considerably more)…
…but we still expect, and are in fact counting on, it to happen again over the next 30 years (here, here).

9) We taxable investors[3] know the only returns that matter are after the tax man cometh…
…but we will continue to evaluate our investment managers and asset allocators solely on pre-tax returns (here, and to once again mention short-selling, this time in a tax aware context, here).[4]

10) The large U.S. equity risk premium (ERP) over the last, say, 100 years was necessary, as for much of the period, most investors owned very undiversified very high-cost portfolios and thus needed a high ERP to properly compensate them…
…but we absolutely expect those 100 years to repeat going forward even though investors can now get exposure to the whole global stock market virtually for free (here).

11) We observe that value spreads, measured the way the nice folks at AQR do, hit their highest levels ever in March of 2000 and then surpassed that (and stayed high for a longer time) in late 2020, and we also observe that meme stocks, ****coins, NFTs, and $4mm revenue Truth Social are, or recently have been, selling for astronomical levels…
…but we heartily believe that technological advances, like social media[5] and the general speed and ubiquity of information availability, have whiggishly made markets more and more efficient over time (here, here, here, here).[6] [7]

12) We believe even modest amounts of leverage is risky…

…but large concentrated bets like being 100% in equities are just peachy keen (here, here).

13) We know that performance chasing, especially over three to five year horizons, is a bad investment plan (it's what we often call "mildly backwards")…
…but it's still a very useful way to evaluate managers, and we hire and fire based on it, either explicitly or implicitly, rarely looking back to see if that helped or hurt us (#3 here, here).

What others am I missing? Please help me fight cognitive dissonance in the investment community[8] and, for that matter, in myself! I'm sure I have some inconsistencies, but by definition, I don't know about them.

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[1] It's not just managers; investors are kind of in on the game (see here, here, and for a non-investing example that feels spot on, here).

[2] Yes, this is the second time I've discussed shorting but it's a very different issue here — moving the dial in ESG vs. just exploiting the short side for alpha.

[3] Obviously skip this one if you're not taxable!

[4] "Evaluate" includes obsessing over micro-differences in investment management fees while often giving up multiple percent returns by ignoring taxes, and in general optimizing (formally or informally) portfolios across asset classes ignoring their often very different tax implications (for instance, buy-and-hold equities are tax efficient, the credit premium typically less so).

[5] People who believe that technology and data availability have made markets more efficient are the same people who believe that social media has made us all like each other more.

[6] I have been meaning to write a piece on my semi-heretical view that markets have gotten less informationally efficient over my career, but I haven't gotten to it for a while now, so no promises.

[7] The flip side is those who believe markets are now so inefficient that old-school value-based investing (not "quant value" but a more holistic Graham & Dodd type value) can't work anymore. Yes, a less-efficient market may make bubbles (and depressions) more severe and last longer. But it's really odd to believe a Graham & Dodd type manager who makes money taking the other side of "Mr. Market's" errors can't win anymore if those errors are bigger than they used to be. It's more logical to say it's harder to stick with such a rational process, but actually better if you can. Crazier valuations for longer introduces practical challenges, but it's a really odd position to say it makes not being crazy a long-term worse proposition.

[8] GoFundMe page forthcoming.

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