When investing is a lot like baseball

Moneyball and markets

The Oakland A's, a small-market baseball team, were struggling. Without the big budget of the mega-teams, they were finding it hard to compete, rarely reaching the playoffs. In a counterintuitive move, the A's turned not to more coaches, but to Harvard-educated statistician Paul DePodesta, who sidestepped conventional wisdom and introduced statistics to the strategy.

DePodesta found the key performance indicator for winning games (players' on-base percentage), and the Oakland A's revamped their lineup accordingly. While coaches and scouts for the rest of the baseball world were looking at things like swing speed and power, the A's found players with great on-base stats, hiring them at lower salaries than the power-slugging stars. As the movie and book *Moneyball* show, this new perspective led to greater success, and Oakland's winning percentages and playoff appearances became consistently above average (with below-average budgets).

Focusing on the right performance indicators to meet goals is equally important in managing money. According to mutual fund manager and advisor AQR, there are four indicators of positive performance in international equities over an extended period of time: 1) the economic performance of the stock's home country, 2) global economic performance 3) the home country's equity price-to-earnings ratios and 4) the global stock market's price-to-earnings ratios.

AQR's study found that, in the short term, ***valuation changes were the primary contributor to stock market performance***. Over the long term, growth of a country's stock market was the strongest indicator. (See Figure 1.) In other words, while short-term stock performance reflects investor sentiment, long-term numbers reflect actual economic fundamentals.

Today, we are all besieged with a 24/7/365 stream of information. We can simply pull out our smartphones to check markets or our portfolios. Television offers experts' thoughts for the next week, month, or year, and with 13,000+ mutual fund choices, there are always those that have performed better. Most input is focused on the recent past and the immediate future.

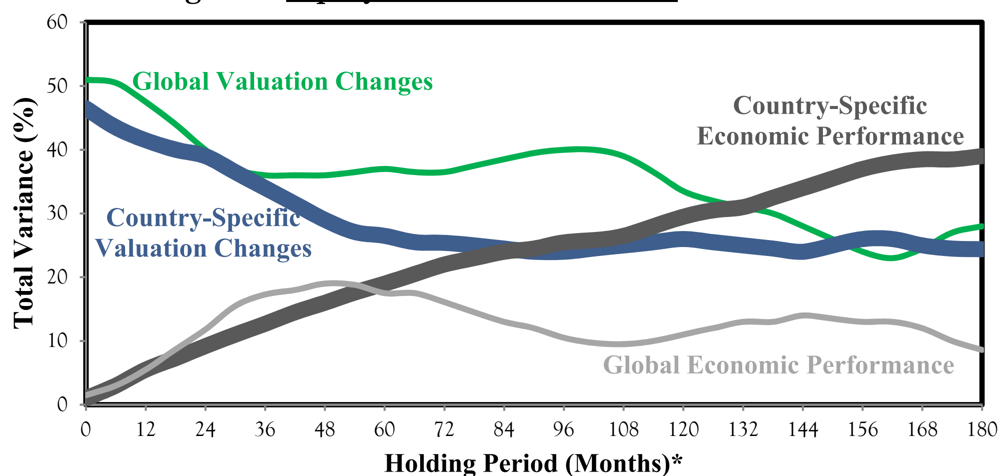
Positive short-term performance can be exhilarating. But winning or losing in the short term rarely predicts long-term performance with accuracy.

Many times in the past, short-term performance did not lead to long-term gain. At the end of 1998, AQR's long-term indicators of economic growth predicted that the U.S. economy would grow at average rates. But as AQR noted, short-term market performance owes more to sentiment than to long-term fundamental growth. The technology bubble was thriving in 1998 and investor sentiment was very bullish, driving prices higher than long-term fundamentals warranted.

Investors with a long-term perspective judged U.S. stocks to be valued too highly to meet long-term return goals. Investors with a short-term perspective were eager to participate in the positive short-term returns of the tech craze. In 1999, the short-term investors were rewarded with a 25% annual return, while long-term investors missed that run-up. However, the tech bubble burst, and the next nine years punished the short-term investor. The 25% gain of 1999 was erased, giving them a 10-year return close to 0%.

While short-term performance does not accurately foreshadow long-term performance, positive long-term performance often does not necessarily translate into good short-term performance. In 2001, the growth rate and stock valuations of emerging market countries suggested this asset class would grow at nearly 15% per year over the next ten years. Investors who focused on the short term watched current negative performance and moved out of the asset class. In 2002, the negative returns of emerging market stocks seemed to validate that move in the short term. But long-term investors who stuck with their convictions (and with emerging markets stocks) were rewarded with an annual return of more than a 15%.

Figure 1. Equity Return Contribution



As many of you might remember, the 2008-09 financial crisis also wiped the slate clean of existing assumptions and practices. We reevaluated our investment goals and reconfigured the key performance indicators that we would then use to reach those goals. Somewhat like AQR, we concluded that focusing on fundamental economics and market prices was the key to producing favorable returns for our clients. We also concluded that, because of the industry's current short-term focus, investors were likely to continue to move rapidly in and out of asset classes, increasing price volatility. We decided that it was not prudent to try to time our investing to reflect this unpredictable volatility. Instead, we would monitor asset prices to determine the attractiveness of securities that present long term opportunities.

To implement this revision of our investment strategy, we realigned our corporate investment team to focus on building long-term and shorter-term portfolios. Those portfolios focus on beating specific rates of growth *in excess of inflation*, with the shorter-term portfolios aimed at preserving capital for investments that could be needed in less than ten years.

We also invested our firm's resources to form Vident Financial, an independent research organization that focuses on finding investment opportunities around the world that mesh with Ronald Blue & Co.'s Principled Reasoning investment framework and that present good long-term potential.

It was not easy for the Oakland A's to dismantle their existing system and to implement "moneyball." In a similar way, it has not been easy for Ronald Blue & Co. to reconsider our long-held beliefs about economics and investments, implementing significant change, as well.

For the Oakland A's, rosters changed and popular power hitters were suddenly gone. Moneyball was a game about patience at the plate, with moviegoers wondering if the system would pay off. By the end of the season, the team made the playoffs, beating many teams with larger payrolls.

For investors, it seems to be harder than ever to keep their eyes on long-term goals. There are so many choices and so many returns they "should" have had. While a short-term financial home run can be fun and exciting, it isn't necessarily an indicator of a winning long-term season. As the research points out, we will continue to monitor the key performance indicators to guide our decisions. For those who can remain patient, waiting for the long-term results, we look for a winning season.