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Epoch Investment Partners, Inc.

GRANT SAMUEL FUNDS MANAGEMENT

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MEDIA RELEASE

Look beyond theory to assess stock specific risk: Epoch

Investors need to remember the basics of what makes a company successful and not focus solely on theories or factors when building portfolios, according to a recent paper by New York-based investment manager Epoch Investment Partners.

In the paper, The Limits of Theory, Epoch portfolio manager Steven Bleiberg looks at Modern Portfolio Theory (MPT), which was first developed in the 1950s, and why it may be hindering investors looking for active management.

“We believe that MPT has been a positive development in helping people to better understand investing. But like any theory, MPT is only a model of the way the real world works; it is not the real world itself.

“It is our contention that over the last 50 years, some investors have become so enamored of the theory that they have lost sight of the real world underlying the theory.”

He says that in MPT, stocks are viewed not as businesses, but as collections of factor exposures.

It has also given rise to the idea that a market index is an optimal portfolio, rather than simply a broad measure of the market.

“This has led people to believe that it is a positive good to make no effort to judge whether a business is worth owning,” he says.

“We need to remember that in reality individual stocks rise and fall because of the success or failure of the underlying businesses; that the market as a whole rises or falls because of the ability of the average business to generate a premium over its cost of capital; and that not every publicly traded company is a business worth owning.”

Mr Bleiberg points out that investing is not a theoretical exercise; it’s about understanding what makes one business succeed while another one fails and that ultimately, there are limits to what MPT can do to help us be successful investors.

In particular, he looks at how the focus on factors has affected investing approaches.

“At the end of a given time period, an analyst versed in MPT will take the returns that various stocks have experienced, regress them against the ‘factor exposures’ of the stocks at the start of the period, and produce a set of ‘factor returns’ – that is, the return associated with a one standard deviation level of exposure to each factor in the risk model.

“But many investment practitioners have become so enamored of this theoretical framework that they reverse cause and effect in the way they think about the world. They seem to think that a stock did well because it had exposure to certain factors that did well, as if the factor returns have an independent existence of their own out in the cosmic ether, apart from the success or failure of the underlying companies.

“However, stocks are more than a collection of statistics such as mean return, variance, or a set of factor exposures.

“Their success or failure as businesses, which is dependent on their ability to meet the needs of customers and to allocate their cash flow sensibly, ultimately drives their stock price higher or lower.

“And it is the success or failure of actual businesses in the real world that creates the theoretical factor returns through the resulting stock price movements. That is, company stock price movements drive factor returns; factor returns don’t drive company stock price movements.

“Or to put it yet another way, markets don’t reward or punish abstract factors; they reward or punish companies because of how well or poorly their business is doing, and that in turn creates what we end up measuring as ‘factor returns’. But we should never lose sight of the fact that those factor returns are a derivative. They are not the starting point.”

“We should never get so caught up in a model that we lose sight of what investing is really all about in the real world. Successful investing in equities is about identifying companies that create value for their owners by earning high returns on the capital that they take from those owners and invest in their business.

“As helpful as it is to have all of the insights that MPT offers – and it offers many – an investor still has to understand the ‘why’ behind a successful business,” he says.

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Grant Samuel Funds Management (GSFM) *was established in July 2007 as a subsidiary of the Grant Samuel Group. In November 2016 CI Financial Corp (CI) purchased an 80 per cent stake in the business. CI is a diversified wealth management firm with fee-earning assets of CAD$186.3 billion (as of 31 December 2017). GSFM specialises in marketing funds managed by high calibre local and international managers to Australian and New Zealand institutional and Australian retail investors.*

Since 2007, GSFM has formed alliances with following investment managers to distribute investment products to Australian and New Zealand clients:

- *New York based Epoch Investment Partners, Inc.*
- *Tribeca Investment Partners, a successful Australian boutique manager*
- *Payden & Rygel, a Los Angeles based independent investment management firm*
- *Triple Three Partners Pty Ltd (Triple3) a boutique research and investment management firm*
- *Munro Partners, a Melbourne-based independent global equity manager*
- *London-based Man Group plc*

GSFM currently represents $6.8 billion funds under management (as at 30 April 2018). For more information about GSFM please visit the website: www.gsfm.com.au