PCI

PRIVATE CLIENT INDICES

Being a Good Loser

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The core principles of successful investing never change—and never will.
Charles D Ellis, Winning the Loser's Game: Timeless Strategies for Successful Investing

For many sports fans, the arrival of summer is heralded by strawberries and cream whilst watching the Wimbledon tennis championship. This year saw the evergreen Roger Federer become the first man to win 8 times and he achieved his 8th win without dropping a single set in the tournament. In his final versus Marin Cilic, Federer hit 23 winners and just 8 unforced errors. Cilic, by contrast, recorded a ratio of 16 winners to 23 unforced errors. Over the tournament as a whole, Federer averaged three times as many winners as unforced errors.

In Charles Ellis's seminal Financial Analysts Journal article from 1975, The Loser's Game, he advances the case that investment management has evolved from an activity where skill and diligence are rewarded with out-performance, to one where the costs of portfolio management and execution have risen to a point where the best strategy for effective investment management is to minimise losses. And he makes his case by the creative use of a tennis analogy to illustrate his points.

Ellis highlights that tennis is, in fact, two different games depending on your ability. Only those professionals at the very pinnacle of the sport, such as Federer, set out with a game plan of winning more points than their opponent (the Winner's Game); almost all other players are more likely to be successful by focussing on a strategy of hitting fewer unforced errors than their opponent (the Loser's Game). Indeed, for a player such as Andy Murray, playing the Loser's Game really well has propelled him to three Grand Slam titles, two Olympic gold medals and a number one world ranking.

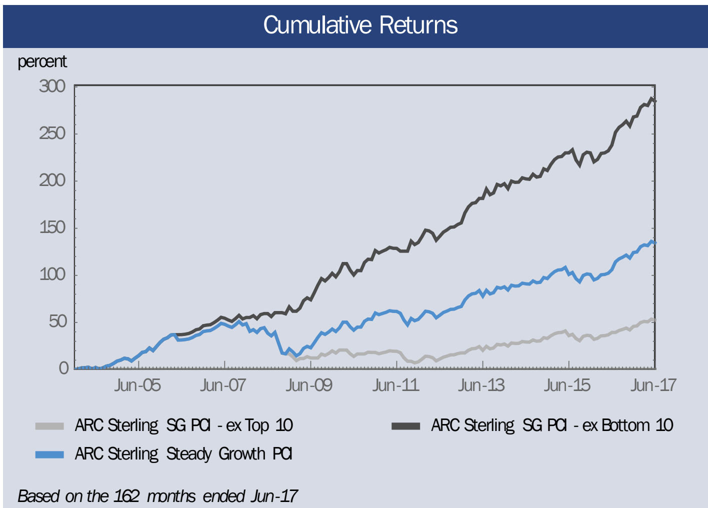
Playing the Investment Management Game

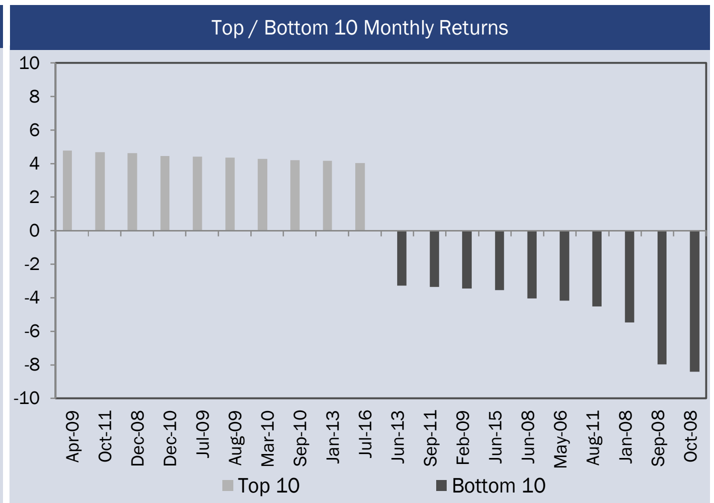
While Ellis applied the concept of the Winner's Game and Loser's Game to institutional investment management, the ideas can be applied to private client discretionary investment managers. For Ellis, active management was analogous to playing the Winner's Game, with active managers seeking to outperform the "market" by picking winners. By contrast, passive investing was playing the Loser's Game. In the opinion of Ellis *"after adjusting for survivorship bias, taxes, and fees the dominance of index funds reaches insurmountable proportions"*.

Whilst this analysis may hold for single asset class funds, ARC believes that it does not hold for multi-asset class portfolios where the winning potential or "alpha" comes not just from superior stock selection but from tactical asset allocation. By way of example, taking a static asset allocation and running a portfolio of exchange traded funds (ETFs) matching that static asset allocation has not delivered consistent outperformance of the average private client discretionary investment portfolio outcome. For multi-asset class investment strategies, using the ARC Private Client universe of over 100,000 portfolio outcomes, empirically Ellis appears to be wrong. On average, active and passive strategies have very similar outcomes over the long term.

However, suppose avoiding making unforced errors is redefined to be minimising losses rather than accepting whatever losses the financial markets deliver. Thus, the perfect Loser's Game would be one where the worst losses are avoided. The typical private client discretionary investment manager serves a community that is particularly sensitive to losses. As a result, the investment philosophies of these managers are often centred on an "absolute return" mind set, the core objective being the compounding of consistent (albeit potentially lower) positive returns and minimising loses. Such an investment philosophy might be described as an archetypal Loser's Game stratagem.

The chart below left plots the performance of the ARC GBP Steady Growth Private Client Index ("PCI") series from December 2003 to date against the same index with a) the 10 most positive months reduced to zero and b) the 10 most negative months reduced to zero. The resultant "funnel" describes the range of possible returns which might be generated by mixing any combination of these two extreme outcomes. The chart below right plots the best and worst 10 months ranked by quantum.





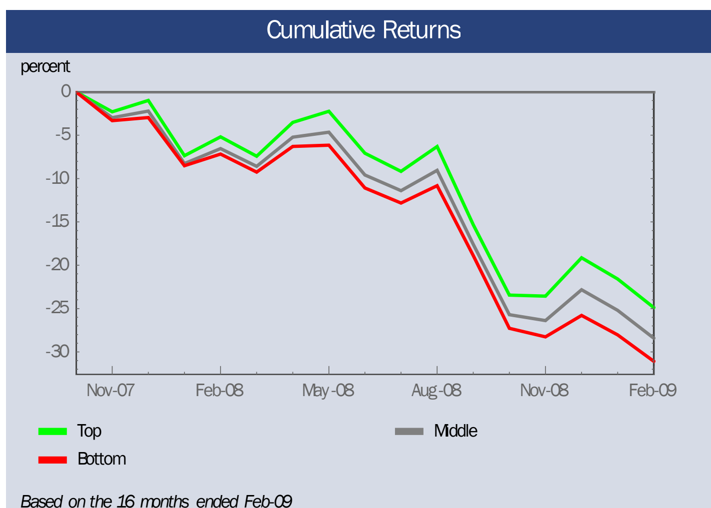
The negative impact on portfolio valuations caused by the global financial crisis in 2008/09 dominates the performance profile, with six of the ten worst months being recorded during this period. The upper boundary of the funnel is the result of playing an almost perfect Loser's Game in which the worst ten months are all avoided. The lower boundary of the funnel represents a disastrous pursuit of the Winner's Game, in which the top ten winning months are missed.

The impact of compounding is evident as the upper boundary pulls away from the ARC GBP Steady Growth index. However, it is also clear from the bar chart that the negative periods of performance are more negative than the positive periods of performance are positive. This outcome is a feature of financial markets – returns are not normally distributed around the mean but exhibit a skew with a higher volume of low positive outcomes, and a smaller number of markedly negative outcomes.

Do Good Losers Win?

Having appreciated the clear advantages of playing a successful Loser's Game, the question arises of whether Good Losers deliver superior performance over an investment cycle. To investigate, the performance of private client portfolios with common risk characteristics has been analysed over three different time periods aligned with three very different market regimes. The first period relates to the Market Fall during the global financial crisis, which stretched from end-Oct 2007 until end-Feb 2009. The second period is the resultant Market Recovery to end-Sept 2010. The final period is much longer, running from end-Sept 2010 until end-June 2017, a period that can be broadly characterised as a Bull Market.

Market Fall – Oct 2007 to Feb 2009

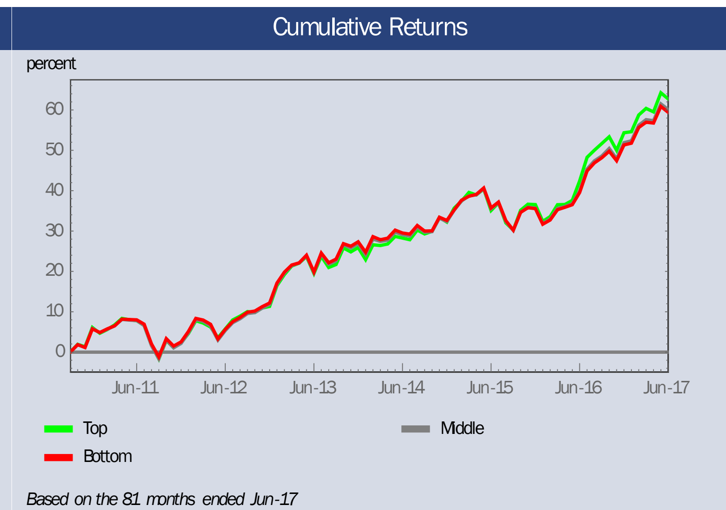


Around 3,000 private client portfolios with a track record from 2007 to date falling within the ARC GBP Steady Growth universe were identified. These portfolios were then divided into three equally sized groups based on their risk-adjusted performance during the Market Fall. The average performance of the portfolios in the top third of outcomes has been labelled Top and is shown in green. The average performance of the lowest third is labelled Bottom and shown in red. The Middle third's average is plotted in grey. As the chart above left illustrates, the Top portfolios on average fell 6 percentage points less during the Market Fall than the Bottom third.

In the Market Recovery phase, the chart below left shows that the Bottom and Middle tercile portfolios marginally outperformed. This result might have been expected, particularly given the speed with which financial market sentiment turned positive and its broad nature. Many of the investments that fell furthest bounced back most vigorously. During the Bull Market run (below right), the Top portfolios slightly outperformed but the differential is not that significant. It appears that in the Bull Market, playing the Loser's Game was certainly not a handicap for private client discretionary investment managers and may even have delivered a marginal benefit.

Market Recovery – Feb 2009 to Sept 2010

Bull Market – Sept 2010 to June 2017

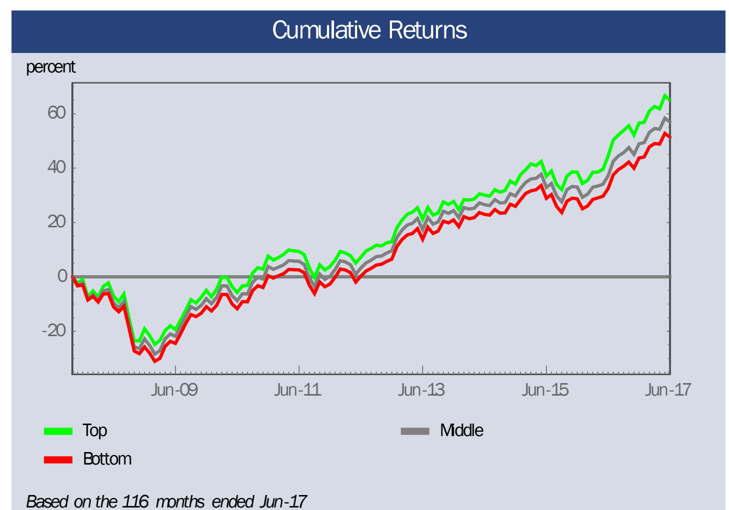


Conclusions

To draw conclusions on the merits of playing the Loser's Game, consider the chart below that plots the performance of the three sets of portfolios over the three time periods taken as a whole.

- **Most of the portfolios that performed best during the Market Fall are still ahead of their counterparts some 8 years later.**
- **The investment strategy of "Being a Good Loser" has produced above average returns for private clients over the last investment cycle.**
- **Investigating track record for a private client discretionary investment manager during difficult markets provides valuable information for potential investors.**

Full Period – Oct 2007 to June 2017



There are a handful of investment managers who have successfully executed the Winning Game, thereby emulating Roger Federer. However, for most private client investors, selecting a manager who adopts the Loser's Game strategy presents the higher probability of outperformance of both the peer group average and a passive portfolio.

For further information:
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