O'Shaughnessy 2.0

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"NUMBERS SERVE TO DISCIPLINE RHETORIC. WITHOUT THEM IT IS TOO EASY TO FOLLOW FLIGHTS OF FANCY, TO IGNORE THE WORLD AS IT IS, AND TO REMOLD IT NEARER THE HEART'S DESIRE."

RALPH WALDO EMERSON

As we launch O'Shaughnessy Asset Management (OSAM), Emerson's words serve as a beacon and a guide to our firm's philosophy. Were he to follow his own advice, I believe Emerson would have been an outstanding investor. During the 20 years that I have been a professional money manager, I have watched investors ignore underlying numbers an astonishing number of times. Whether it was the crash of 1987 or the bursting Internet bubble of the late 1990s, the behavior of investors *never changes*.

Investors prefer opinion and rhetoric over the cold, hard facts, for it allows them to follow flights of fancy and ignore the world as it is. How else could investors in the late 1990s price America Online at 635 times trailing earnings, giving it a negative Economic Value Added (EVA) of 10.3%? In plain English, that meant that investors were betting that AOL's entire $130 billion market-cap depended on *future* growth. Back then, if investors had let numbers discipline their opinions, they would have realized that just to *maintain* that valuation, AOL would have to sign up one-sixth of the world's population, at full price—year after year! In April of 1999 I wrote a report called *The Internet Contrarian* outlining the madness of Internet stock valuations and was broadly ridiculed for being out of step with the "new" economy.

With hindsight, the Internet crash appears inevitable. Yet similar things happen all the time. All you need to do is look at today's credit crisis and the bursting of the housing bubble to see that events like these are not the exception in markets, they are the rule. Most investors—including professionals—usually prefer the colorful story to the underlying factual evidence.

Taking Advantage of the Facts

This gives us an important and exploitable opportunity. What we do here at OSAM is rational and straightforward—we arbitrage human behavior and follow the facts. This is the cornerstone of our investment philosophy: Investors who use time-tested, well defined stock selection strategies in a systematic, disciplined and unemotional fashion have a huge advantage over most other investors because they let numbers discipline rhetoric.

All of our stock selection strategies start with a rigorous test using as much market data as possible. In many cases, we are able to conduct a monthly test back to the early 1960s. By seeing how well a strategy performs in a wide variety of market conditions we glean vital information and can identify strategies that can withstand adverse market conditions and go on to perform well. What's more, this data gives us insights that conventional managers cannot have because without a defined strategy, they have no way of knowing what securities they might have purchased 25 or 30 years ago.

One of the great advantages of our way of investing is that we can see how our strategies performed in the bear market of 1973-74 or the crash in 1987. With this information we can see how badly high-flying stocks can be punished in a downturn. That's why we were sounding the alarm bell in 1999—far from being "different this time," as the Internet mantra-of-the-day went, we knew from our long-term studies that it was eerily similar to the market boom that preceded the bear market in the early 1970s.

When conducting our tests, we look for strategies with excellent risk-adjusted returns, reasonable risk characteristics and robust performance in a variety of stock market environments. Only after we have exhaustively tested a strategy will we put it into practice.

The Rewards of Discipline

But knowing and doing are two very different things. I believe we have succeeded in the past because we never deviated from our underlying strategies. I passionately believe that it is this steadfast discipline that is responsible for our performance. Conventional managers often waver when the market turns against them. They might let short-term market conditions tempt them to change their course, many times abandoning their underlying strategy right before it is getting ready to rebound. By staying true to our strategies through thick and thin, we are able to reap the rewards of patience and disciplined perseverance. Woody Allen famously said that 80 percent of success is simply showing up. I believe that the lion's share of excess market performance is earned by adhering to a superior strategy no matter what happens in the short-term.

It's easy to claim that you are a disciplined investor, but we have over a decade of real time results to back up our claims. Over the last 10 years, we have seen a stock market bubble; a bear market more severe than any since the 1970s; turmoil in the credit and real estate markets and a rebound of value and small-cap stocks. Through it all, we've remained true to the underlying strategies first outlined in *What Works on Wall Street* more than 11 years ago. By doing so, we let the evidence guide us and remove what I believe is the single greatest threat to superior investment performance: our human, emotional natures.

This is much harder to do than you might think. That's because all of our evidence is from the past, and therefore stripped of all of the full-blown emotions of the present. Many people trick themselves into believing that they knew an event was going to happen *before the fact*, but the truth is, few do. I know of very few people who were alarmed when the NASDAQ was hovering at 5,000 in March of 2000, yet most now believe that the ensuing crash was inevitable and that we should have seen it coming. Behavioral economists call this *hindsight bias*, and it is a very difficult thing to overcome, even when you know about it.

Think about how you might respond to a poorly performing investment. Chances are, you would want an explanation from your fund's manager as to why he or she wasn't doing well. In all likelihood you would have doubted your choice, pulled your investment and put your money with a new manager with better recent returns. It is this typical and myopic emotional response to short-term performance that gives disciplined investors an opportunity to succeed over the long term. And the good news is, unless we fundamentally see a change in human nature, this opportunity will continue.

If you go back and read the very first commentary that I wrote for my first

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company, O'Shaughnessy Capital Management, on December 10, 1997, you'll see I haven't changed my tune. Here's what I wrote then: "You need long-term strategies to reach long-term goals, and paying attention to short-term fluctuations in the stock market is one of the most destructive things you can do for your long-term financial health."

On this score, expect to be reading the same sentiments from me in 2017.

Investors should keep in mind that there is no certainty that any investment or strategy will be profitable or successful in achieving investment objectives. Past performance is not an indication of future results.

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