Consider this

Un-natural advantage

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Aadil Omar
Head of Equity Research

Michael Phelps has a relatively long torso and relatively short legs. At 6 foot 4 inches, he has a torso of a man who is 4 inches taller and the legs of a man 8 inches shorter. His disproportionately large chest enables him to power through the water, while shorter legs produce less drag (or water resistance). Oh, and that's before we get to his size 14 feet and 6-foot 7-inch wingspan. Phelps was built to swim fast. Based on nothing more than his physical attributes, it would not be a stretch to infer he had a natural endowment for moving through water. Having cultivated and trained those latent characteristics, Phelps is the most decorated Olympian of all time, sporting 23 gold medals. I would not be remiss in suggesting he was born with a natural advantage.

This sort of anatomical advantage is not unusual to observe in the domain of elite physical performance. A simple internet search will reveal all sorts of biometric data on elite athletes from which one can easily connect the dots to outstanding performance. But the further from physical competition one veers, the less apparent these explicit advantages and the trickier it becomes to rely on deductive reasoning to predict performance.

Take chess for instance. If you asked me what makes Gary Kasparov or Magnus Carlson the best chess players to have competed in the game, I'm not sure I could answer that question by succinctly identifying an explicit advantage. In fact, even if I were to conduct an in-person interview, without delving into accolades or track record, I doubt one could conclude as to where Kasparov's relative advantage comes from. To answer the question, some study and analysis of each of their games is required. You may well need to segment their games, perhaps along the lines of opening-, middle- and end-game to determine which part each player excelled at. You may even become more granular and study the use of each piece on the board and perhaps conclude that whilst Kasparov is a maestro at the middle game, using his bishops with maximum effectiveness, Carlson is much better at the opening, making great use of the knights.

This is all made up -- I have no idea how one would evaluate the effectiveness of a chess player -- but the point I'm trying to make is that it is not like Phelps when it comes to competitive swimming. There are layers to wade through before you reach an element that starts to resemble an advantage. And even then, these conclusions are unlikely to be beyond a shadow of a doubt. What you do know is that Kasparov and Carlson are impeccably talented at the game of chess, but we may not get to a consensus of exactly why that is the case.

The differences between the Phelps- and Kasparov/Carlson-type advantages are somewhat intuitive, but we can appreciate that the more complex and multi-faceted the game, the more difficult it becomes to articulate the advantage. Both games, however, occur in a relatively static environment where outside variables or shocks play no role whatsoever -- i.e. there is no random variable. Competitors know exactly what is required to win and what variables are at play at any moment. Trying to determine the explicit advantage in a real world setting where random variables are present gets even trickier.

Non-explicit

I have always found the intuition around an advantage or "edge" in investing tricky. Any advantage a money manager might possess will not be explicit the way a Phelps advantage is. Competitive advantages in the money management industry tend to be rather opaque. Observations are tricky and description almost always must be analogous if not conceptual. A basic internet search seeking the sources of an edge in investing revolves around ideas such as discipline, patience, risk tolerance, analytical rigour and other generalisations. Very rarely can one find an explanation detailing an explicit advantage unless it is in some way related to the possession of material non-public information[1]. This is not to say that advantages in money management do not exist, but rather that any advantage is unlikely to be explicit in nature.

In highly competitive games, especially those played by teams, this makes sense for a variety of reasons:

- For one, an explicit advantage, once it is out in the open, can be replicated and ultimately competed away. Think about the computer system Deep Blue that ultimately beat Kasparov in chess once it was able to compute enough of the game. A similar phenomenon can be observed in professional poker, where optimal game theory is being mastered by relative newbies, thereby shrinking the distance in the leaderboard.
- Another reason explicit advantages are not commonplace is the presence of random variables in the world of investing - things can and do happen that were not only unexpected but that were unforecastable. Operating in an environment completely foreign to you is antithetical to an advantage.
- Finally, the chances of being remarkably better than equally resourced opponents is slim. Small advantages are more likely, but these should be meticulously managed and built upon to be sustainable.

I've spent some time arguing against an explicit advantage in the money management industry, but I will re-iterate that this does not imply a manager cannot have an edge. Often, an edge is an emergent feature of a clear philosophy and a well-executed process. It only shows itself over time.

As much "what" as "how" we play

"All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it" – Warren Buffett

Unlike professional swimmers and chess players, investors have much greater degrees of freedom. Within the confines of a mandate, an investor can dial up risk or step back based on market dynamics. Coincidentally, this means an investor can narrow the "field" to the point where an advantage is more likely. In contrast with Kasparov, who cannot simply eliminate the rooks from the chess board just because he happens to prefer bishops, an investor can opt into the sort of investments they believe offer the best prospects. It is therefore not uncommon for investors to be labelled along the lines of their preferred "playbook", such as value investor or activist trader. These diminutive labels are not that descriptive in detailing the source of an edge, but closer scrutiny of an investment philosophy and process can be illuminating. Warren Buffet famously pointed to three key elements that he attributes much of his investment success to: 1) stay within your circle of competence; 2) invest with a margin of safety; and 3) invest in companies that have a sustainable competitive advantage and are managed by capable stewards of capital.

At M&G, we have similarly been focussed on a few key tenets on which we rely to help navigate the market and inform our investment decisions:

- Focus on long-run anchors of value
- Minimise the short-term noise
- Construct portfolios in a risk-conscious manner

Whilst I maintain that explicit advantages are not apparent in the money management industry, looking back it appears that an emergent edge may well be prevalent among certain managers. As in any game, a demonstrable and consistent track record is the closest thing we have to proof of an edge.

[1] Readers interested in an example of these sort of explicit advantages may enjoy the entertaining book "Flash Boys" by Michael Lewis