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Making rules, breaking convention

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One of my most prevalent characteristics is that I am ridiculously scatter-brained. And before you even go there, it's nothing to do with aging. In my prime, I misplaced my passport and boarding pass while in an international departure lounge. Tom Hanks's character in the movie, The Terminal, nearly became my life story. The way I manage this charming idiosyncrasy is to have a series of rules, rituals and mnemonics that help me to keep track of what I need to do, or at least ensures that I can follow the breadcrumbs to where I need to be and what to do when I get there. Perhaps this is one of the reasons that Gryphon's rules-based approach to investing resonates with me, as it does.

Rules-based investing demystified

The whole idea of rules-based investing is not widely understood. Most people, certainly most investors, will be familiar with the concept of indexation, sometimes called passive investing (inappropriately to my mind – it's actually an active approach with a passive outcome). Rules-based investing, broadly speaking, is a simple concept that is elegant and sophisticated in its execution.

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Well-known author, Atul Gawande, wrote a book called The Checklist Manifesto. In this book, he identifies the complexity of our lives and shows how this can be best dealt with using the simple approach of a checklist. To quote from the book: *"Here, then, is the situation at the start of the 21st century: we have accumulated stupendous know-how. We have put it in the hands of some of the most highly trained, highly skilled and hardworking people in our society. And, with it, they have indeed accomplished extraordinary things. Nonetheless, that know-how is often unmanageable. Avoidable failures are common and persistent, not to mention demoralising and frustrating, across many fields – from medicine to finance, business to government. And the reason is increasingly evident: the volume and complexity of what we know has exceeded our individual ability to deliver its benefits correctly, safely, or reliably. Knowledge has both save us and burdened us."*

He goes on to assert that we need a strategy to address this situation, to manage this overwhelming amount of content and complexity. We need to be able to take advantage of people's knowledge and experience but also accommodate our human inadequacies. And the proposal he makes that will enable us to do this: a *checklist!*

Perhaps this is a concept that not many of us have ever given much thought to. Professionals who take on the responsibility of people's lives, based on the decisions and actions they take, will invariably be much more cognisant of the impact of failure, the lack of a successful outcome.

The aviation profession is a good example of where checklists are used... and what about the engineers and construction professionals, involved in building a shopping mall or a skyscraper? If you look at the construction plans drawn up, the checks and balances are incredibly detailed. If a roof falls in or a building collapses, the risk of fatalities is high and the people responsible could end up going to prison, if found to be negligent.

Undoubtedly, these professions took quite some time to get the point where they realised that they needed checklists.

The medical industry is an obvious example of a profession where lives are at stake. However, even in the medical profession, up until fairly recently, checklists were seen as the boring stuff that nursing staff dealt with. Doctors with years of training and specialisation didn't see any real need for checklists. And then, in 2001, a critical care specialist at John Hopkins Hospital, Peter Pronovost, became very concerned about the high rate of infection suffered by patients during the fairly routine procedure of inserting a central line. He decided to develop an extensive checklist with the intention of bringing the onset of infection under control. Once he implemented this list in his own hospital, infection rates dropped **from 11% to zero** in the year that followed, making it very clear that highly skilled doctors were unaware that they sometimes skipped a simple step in the procedure, and this had the potential to increase the risk of infection. The implementation of this simple checklist avoided infection, prevented deaths and saved millions of dollars.

Back to aviation – in the early days of aviation, flying was a 'by-the-seat-of-the-pants-thing' and a pilot's life expectancy was a lot lower than the average man on the street. For pioneer pilots, failure attributed to pilot error could be reasonably explained as the consequence of **ignorance**; pilots simply didn't know what to do when a new problem or situation arose.

However, if a modern-day aircraft crash is the result of pilot error, given the training and checklists pilots are supposed to follow, the error would more likely be seen as **ineptitude**. The knowledge exists, but the pilot failed to apply it correctly.

These are just some of the insights available in *The Checklist Manifesto*. The book describes how, as industries and professions mature, the need for checklists increases. It is our view that, as in aviation and the medical profession, the investment industry has also matured. However, we still see frequent failures that can no longer be attributed to **ignorance**. We have more data and knowledge at our disposal than ever before. So, this begs the question: Is it **ineptitude**? It appears that many investment managers, despite being surrounded by mountains of data, are in reality, flying by the seat of their pants!

Where are we going with this? Well, this book gave us a platform and a lexicon to develop and explain our take on the concept of rules-based investing.

At Gryphon we base our investment process on the principles of the checklist approach – what we call rules-based investing. To our mind, there are two major threats to investment returns – costs and emotion. Rules-based investing mitigates both of these through indexation and our asset allocation philosophy.

A meaningful element to rules-based investing is not basing investment decisions on forecasts. The world is awash with predictions that bombed:

> *"Who the hell wants to hear actors talk?" –*
> H. M. Warner, co-founder of Warner Brothers.

> *"This telephone has too many shortcomings to be seriously considered as a means of communication."* – Western Union internal memo.

> *"The horse is here to stay, but the automobile is only a novelty, a fad." –*
> President of the Michigan Savings Bank, advising Henry Ford's lawyer not to invest in the Ford Motor Company.

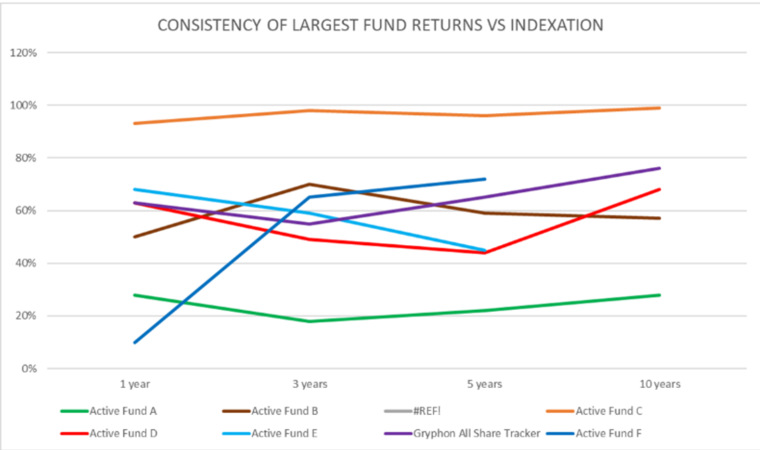
Howard Marks, investor, writer and co-founder/chairman of Oaktree Capital Management, accurately expresses our take on forecasting when he explains why forecasts are rarely helpful: '*In order to produce something useful – be it in manufacturing, academia, or even the arts – you must have a reliable process capable of converting the required inputs into the desired output. The problem, in short, is that I don't think there can be a process capable of consistently turning the large number of variables associated with economies and financial markets (the inputs) into a useful macro forecast (the output)."*

For this simple reason, our investment philosophy is not dependent on forecasts, predictions or expectations, but on data-based rules.

> *'There are two kinds of forecasters: those who don't know and those who don't know they don't know.' John Kenneth Galbraith*

Indexation

It's a common notion that the only advantage of **indexation** is the lower costs. Costs are an obvious advantage to investors, but that is not the only consideration in selecting an index fund. The benchmark the fund tracks is important, how it tracks the benchmark, i.e., the tracking error, as well as the liquidity of the fund should also be taken into account. It's all very well getting great returns, cheaply, but not if you can't access your funds when you need to.



Date: 30/09/2022
Source: FE Analytics Profile Media

Another important factor is consistency: a broad index fund such as the Gryphon ALSI Tracker has delivered consistent, upper quartile performance and, over time, this means respectable returns for investors. There will always be active funds that outperform the market – the challenge is knowing which fund will, when, and then for how long.

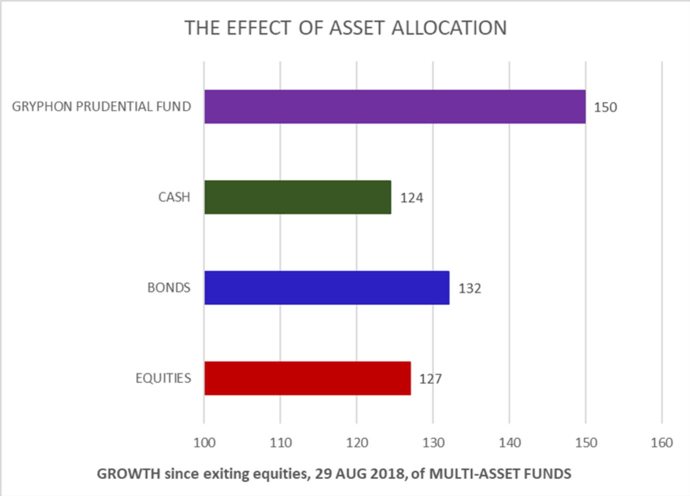
Asset allocation

Research has proven that **asset allocation** contributes more to investors' returns than stock selection. Common rhetoric currently is that markets can't be timed, that it's "time in the market" that matters. We dispute that unreservedly and counter that market cycles can be identified and avoided if so chosen.

Distinction should be drawn between **primary** and **secondary** cycles. What we've learned is that it *is* possible to call the primary market cycles reasonably consistently. While it may also be possible to read the secondary market cycles, we have not yet been able to identify reliable factors that consistently predict these cycles accurately. Normally secondary cycles are short in nature, lasting about three months and not more than 10% in size. They are usually driven by sentiment – greed and fear – and create a lot of noise in the market, but little direction.

Over a period of 20-something years Gryphon has identified a number of historic, data-based indicators that assist in signalling the appropriate time to get into or out of equities. These indicators are based, among other things, on the business/economic cycle, commodity prices, company earnings, interest rates and inflation.

It is a simple concept; the intricacy is in its implementation. The challenge is being disciplined and focused enough to be able to ignore the noise and the emotions caused by fear and greed, the FOMO that comes as a result of investors constantly comparing and competing. By unflinchingly sticking to the rules and following the checklist, this strategy has delivered top decile performance over time.



Source: FE Fund Info
Date: 29/08/2018 – 30/09/2022

This rules-based approach got us out of equities in August 2018. As you can see from the chart, the Gryphon Prudential Fund has outperformed every local underlying asset class since then, and at considerably lower volatility than would have been experienced invested in equities.

In conclusion, a final extract from the book, "*One essential characteristic of modern life is that we all depend on systems – on assemblages of people or technologies or both – and among our most profound difficulties is making them work… We're obsessed in medicine with having great components – the best drugs, the best devices, the best specialists – but pay little attention to how to make them fit together well…We don't study routine failures in teaching, in law in government programs, in the financial industry or elsewhere. We don't look for the patterns of our recurrent mistakes or devise and refine potential solutions for them. But we could. We are all plagued by failures – by missed subtleties, overlooked knowledge, and outright errors. For the most part, we have imagined that little can be done beyond working harder and harder to catch the problems and clean up after them.*

Instead, we can choose to accept our fallibilities, recognise the simplicity of using a checklist. Indeed, against the complexity of the world, we must. There is no other choice. When we look closely, we recognise the same balls being dropped over and over, even by those of greater ability and determination. We know the patterns. We see the costs. It's time to try something else. Try a checklist."

Why not try rules-based investing?

Glacier Research would like to thank Megan Fraser for her contribution to this week's *Funds on Friday*

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Megan has been involved in establishing business development networks in financial services for nearly 40 years. Having worked for Norwich, Investec IMS, Coronation, Stanlib, Fraters, SI, and Aylett & Co, she has a acquired a breadth of experience as well as valuable insights in this time. Her current role with Gryphon provides the opportunity to create awareness and appreciation for the unique, innovative investment approach delivered by this well-established, rules-based investment house. Beyond the office, her passions include reading, travel, holistic health, and trying to get the whole world to embrace meditation.