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DOES FORM MATTER?

Matthieu Dulguerov
Senior Research and Product Manager,
Head of Equities

FORM IS KEY

An investment vehicle is a financial product that provides investors with asset management services. Behind every product – Berkshire Hathaway, for instance – there is substance and form. The substance is the securities portfolio, resulting from an investment process applied to an investment universe. The form is the legal framework, addressing all regulatory and contractual criteria affecting the investment vehicle.

You may be among those who consider that the form chosen by Warren Buffett to implement his investment strategy is incidental and that his financial success, and that of his recently deceased associate, Charlie Munger, is solely due to their investment decisions. If so, we will attempt to convince you otherwise, by demonstrating that a necessary condition for a product to succeed is the correspondence between its substance and its form.

IMBALANCE BETWEEN SUBSTANCE AND FORM

Let's take the example of a product whose investment decisions are taken based on a long-term approach and which offers liquidity, meaning the ability for investors to convert the product into a readily available sum of money. Until now, the product in question – which only invests in publicly traded companies – has shown a financial performance well above its benchmark index, leaving many investors clamouring to buy it. Whenever the manager meets a potential investor, he delivers the same message, that no one should buy the product unless they have a time horizon of at least five years. What do you think would happen if the product's valuation were to fall by 30% within a period shorter than this time horizon?

"The lack of harmony between the product's substance and form inevitably leads to failure, regardless of the quality of the substance."

Doubt would set in among investors, despite numerous warnings about the need for a time horizon of at least five years, eventually triggering their survival instinct and encouraging them to sell at the worst time for fear of losing everything. And this premature investor flight, born out of a mismatch between substance and form, would have further ramifications, including negative outcomes for stakeholders. Firstly, investors who bought into the product shortly before and sold just after it fell would have suffered significant losses. Secondly, those investors would hold a grudge against the product's management company, damaging its reputation. Finally, the product manager would be dismissed for incompetence. He might be blamed for not selecting companies capable of withstanding price falls, for example.

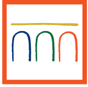
EVEN GOD WOULD GET FIRED AS AN ACTIVE INVESTOR

This last argument is absurd. Regardless of the manager's skill in selecting companies, he cannot be immune to periods of underperformance. To illustrate our point, let's take the example of a portfolio weighted according to the market capitalisation of its constituents and comprising the fifty companies that will have the best performance over a five-year period from among all the companies in the S&P 500 index. At the end of the five years, the fictional portfolio's composition and weighting are revised based on the principle outlined above. And so on from the beginning of 1927 to the end of 2009. This assumes that we know with certainty, five years in advance, which of the fifty companies in the index will have performed best at the end of the period. Not surprisingly, this portfolio's historical performance has been excellent. It has significantly outperformed the market, posting a return of 29% per year from the beginning of 1927 to the end of 2009 – a period of more than eighty years. But what is surprising is that at one point, this fantasy portfolio collapsed by more than 75% and at other times it fell by much more than the market!

This portfolio was presented by Wesley Gray in a study published in 2016 entitled *Even God would get fired as an active investor*. The title may be catchy, but it could be more precise. *Even God would get fired as the long-term investment manager of an open-end fund with daily liquidity* would have been more appropriate. Indeed, this title clearly indicates that the lack of harmony between the product's substance and form inevitably leads to failure, regardless of the quality of the substance.

THE IDEAL FORM IS A FUNCTION OF THE SUBSTANCE

In conclusion, here's a simple and effective proposal to avoid the unfortunate consequences of an imbalance between substance and form. Ideally, and contrary to established practice, observed liquidity should never be less than a financial product's time horizon. The ideal form therefore becomes a function of the time horizon of the investment strategy. Investment products available in private markets already benefit from this advantage. We envy their form and aspire to imitate them someday. For now, we strive to transparently communicate our management actions, in the hope that, regardless of market fluctuations, our clients will stick to their initially selected time horizon.



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