Consider This

The curious incident of the dog in the night-time

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postulate
Noun [formal]
/ˈpɒstjʊlət/

1. A thing suggested or assumed as true as the basis for reasoning, discussion, or belief.
   "Perhaps the postulate of Babylonian influence on Greek astronomy is incorrect."

It is tempting to subscribe to investment postulates - those (often large and sweeping) generalisations that underpin the wisdom espoused by investors of great repute (and great wealth). These postulates are not always clearly defined nor articulated in plain language, but spend a few years in the industry, and you soon assimilate what they are. They are not easy to dispute. Often, they are intuitive, and one would have little reason to doubt them.

To illustrate my point, consider the following (paraphrased) mission statement from a well-known US-based fund manager: *"We aim to own high-quality companies trading at a discount to intrinsic value, run by able and incentivised management partners."*

The above statement is not at all controversial. In fact, it is logical, sounds well-thought-out, and similar sentiments have been expressed by many investment professionals over time. Subscribing to such a philosophy would not be contrarian. Now, before we dig any deeper into the underlying postulates, let's take a small detour through one of Sherlock Holmes' well-known adventures.

Conspicuous by absence

In *"The Adventure of Silver Blaze,"* one of Sir Arthur Conan Doyle's Sherlock Holmes stories, Holmes solves a mystery involving the disappearance of a famous racehorse named Silver Blaze and the murder of its trainer. The pivotal clue in this case is famously known as "the curious incident of the dog in the night-time." When Holmes points out this incident, Inspector Gregory is puzzled, responding that the dog did nothing in the night-time. Holmes clarifies that this was precisely the point - the dog did not bark. Holmes deduces from this that the dog must have known the intruder, suggesting that the criminal was someone familiar to the dog. This clue leads Holmes to solve the case, revealing that the horse's disappearance was an inside job orchestrated by the trainer's own household.

Returning to the investment mission statement which, at face value, seems quite acceptable, what might one be overlooking? What the mission statement does not detail but very much relies upon are the underlying assumptions that must hold true for the mission to be achievable - that the manager has an edge:

1. The investment manager must be skilled enough to spot a high-quality company.

2. Some of those high-quality companies must be trading below intrinsic value, which the manager should also be able to identify.

The less obvious and perhaps somewhat hidden postulate (the dog that does not bark) is that the assumed manager's edge is exploitable. More specifically, the market must (over a reasonable period) recognise and correct these differentials in quality and price, thereby earning the manager and their investors an excess return. This is the important piece of the investment puzzle that, if it were not true, would undermine the investment philosophy. If the postulate is not critically re-evaluated, the manager may underperform for lengthy periods or even lose their edge all together.

Edge erosion

Assumptions are important in complex environments, particularly those that allow us to pin down a basis and continue reasoning along a problem set. They create necessary structure. Much of the body of knowledge in mathematics is built upon key foundational assumptions (called axioms). They provide the logical structure for developing complex theories like calculus, abstract algebra, and topology. However, unlike mathematics, the world of economics and finance (a system operating in the wild) does not have the luxury of being governed by ironclad laws that are beyond reproach. There are simply too many variables acting on the system, where each variable can evolve toward completely new states, thereby impacting the system quite dramatically.

For instance, a market operating under perfect competition would start to look very different as one competitor breaks out to become the dominant market leader. Capital returns would also differ across the spectrum of market competition. It is interesting to note that at the point at which a market starts to resemble a monopoly, attention is usually drawn to the woes of those players left behind, neglecting the now-market leader. But the altered market has implications for both - the strategy that got you to the top may not remain effective in an environment where there was no apparent dominant player. Continued execution of the strategy may or may not yield continued success. This is why sweeping generalisations can be ineffective in these large and complex systems.

Then there is the impact of new variables or external stimuli that have not yet been present in the system. Technology has little influence on mathematical axioms but can and does fundamentally change our economic reality. A similar thing can be said about regulation, which has a major influence on the competitive landscape, flow of capital, and numerous other aspects, much of which we cannot foresee.

This point is notable and worth elaborating: in a system open to external stimuli (a system out in the wild), new variables may alter the environment such that the system no longer operates in the same way as it had historically. This is another way an investment edge may erode over time.

Evergreen is not forever

"Do more of what works and less of what doesn't"
*-Steve Clark (Clark Capital)****

Maintaining an edge in a complex system is an exception. An estimated 99.9% of all species that have ever lived on Earth (more than 5 billion species) are now extinct. Investment postulates are tempting to accept as bedrock truths, especially those that have historically supported an investment edge. They also make our jobs easier and reduce the complexity of the financial world to manageable bite-sized chunks. But a structure only has as much integrity as is supported by the assumptions underpinning it – both explicit and implied.

Whether in investments or other domains, the ability to question assumptions (when results fall short of expectations) and recalibrate strategies is what separates fleeting success from sustained achievement. It is important to continually investigate what remains unsaid or overlooked.

Are there any dogs not barking?

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