Prospering as David in a Land of Goliaths

In poker, they say that if you look around the table and cannot spot the mark, then it's you.

As a retail investor surveying a landscape populated by gargantuan pension plans, hedge funds armed to the teeth with technology, and rapacious investment banks the poker aphorism may seem discouraging at first blush. Fortunately, as a retail investor you have a few advantages on your side. Furthermore, to mix legends, the giant pools of capital have their own Achilles heels.

Investing is not Gambling

With alarming frequency, I read screeds from the blogosphere bemoaning investing as a rigged roulette table. Perhaps - but only because that roulette table is speculation rather than investing. The solution is simple: play that zero sum game for fun if you want – just don't expect to make money at it. Investing is the application of capital in the interest of generating wealth. Find companies with management incented to generate wealth and create a larger pie and a history of sharing that pie equitably among its investors and you completely change the dynamics of the exercise. No longer will you need to "beat" others to prosper, but you can simply grow your wealth along with all the other investors.

Of course, the best will and desire on the part of management does not always translate into gains. Events conspire, plans go awry, the environment changes, etc. and losses ensue. However, with a selection of high quality, "shareholder friendly" holdings you are likely to have more winners than losers over time.

There are More Tables

If you don't fancy the players around your table, you can always move.

Most institutional investment funds have a minimum size for their investments which directs them to a certain class of stocks. There were more than a few times at Teachers' Pension Plan when I was told to cease work on project because it just was not going to allow the fund to put enough capital to work. In many cases, these large funds will gravitate to the larger investment even if the risk/return expectation is decidedly inferior. This is why Panoply often includes some quite small companies in our clients' portfolios.

Another example is family controlled firms. Many institutions and hedge funds avoid these companies, in part, because they are not likely to be taken over. While that is true, they also tend to have less risky balance sheets and are less likely to make unprofitable acquisitions.

Play for Lesser Stakes

Many hedge funds have very high hurdle rates for their investments. Some hedge funds won't consider an investment unless they think they can make 30% or more per year on it. This leads them to invest in relatively risky assets where the upside is not constrained. To switch to sports analogies, whether they

admit it or not, they are effectively swinging for the home run. Their focus can allow you to bat singles where the upside is limited but still worthwhile and the downside is more modest. I tend to think in terms of reward to risk. If this ratio is more than 2 it is worth considering as an investment.

Take your Time

How often have you heard a large fund say "We Invest for the Long-Term" or something similar? In reality, few institutional investors actually follow through on this sentiment consistently. Many such funds actually believe in long-term investing and would like to do it. However, the people making the decisions are the portfolio managers and their interests can be coloured by the desire to maximize their bonus for the year meaning they cannot wait years for an investment to pan out.

Often you will hear a portfolio manager say that such and such company is good value but they are not buying it "because there is no catalyst". Of course, once the catalyst becomes evident, it is too late. If it's a quality company in the habit of distributing its earnings to shareholders through dividends, why not buy it, collect the growing dividends, and wait for the catalyst? Many institutional portfolio managers are loath to do this for fear that they will lose their bonus or be fired while waiting. As a small investor, however, no one is going to fire you.

Agency Problems

For almost all institutional investors, the person making the investment decision is not the ultimate beneficial holder of the investment. This creates the potential for what are called agency problems. The portfolio manager is the agent for you as a mutual fund holder or a pensioner or a hedge fund investor. The portfolio manager wants to make her bonus and avoid being fired. You want to make money. Those are not always the same objectives. Here are some examples where agency problems can work to your advantage as an independent-minded investor:

- No matter what they say, almost all institutional investors are acutely aware of how their investments stand relative to an index. Remember when Nortel was over 30% of the TSE? Every institutional portfolio manager knew that number. Many of these managers, including me, thought it was a very poor investment at those levels, but we held some anyway. Why? Because we had seen other, braver, souls hold none and lose their jobs.
- Today, resources and energy represent over 50% of the TSE. If Chinese demand slows, almost all of these companies are going to drop together. Yet it is even more painful for an institutional portfolio manager to avoid these sectors than it was for him to avoid Nortel in 1999.
- Institutional investing today is a lot more exciting than it was 15 years ago. You have private equity, commodity, derivative, absolute return, and a myriad of other investing strategies. Leaving aside the question of whether these strategies add more return than risk, they certainly do look impressive. I have actually heard an institutional portfolio manager say "I am not being paid to invest in Coca-Cola". But what if Coke, or more broadly, all large, successful multinationals were actually the best investments out there in terms of reward to risk? Well, he'll probably stick with flashy and let you buy the boring and profitable companies.

Conclusion

You and I are David. However, we have advantages and can be successful investors if we play to our strengths:

- Wealth creation – You do not have to vanquish the Goliaths to prosper
- Size – You can invest in smaller companies the Goliaths ignore when you have conviction
- Expectations – Think in terms of reward to risk and you will have less competition for your investments
- Time – By investing in companies with growing dividends you can afford to wait for the catalyst
- Agency problems – These aren't your problems. Invest in quality, shareholder-friendly companies at reasonable prices