We invest differently, but not just for the sake of it

By Ross Reuvers & Edo Brasecke

One thing we are clear about at Methodical is that we are doing something different. Our equity fund works and looks like nothing else on the market.

This is not out of simple belligerence. We are not natural contrarians who want to be divergent just for the sake of it.

Our motivations are quite the opposite. We don't deliberately build high-conviction portfolios that are nothing like the benchmark. In fact, we have no conviction at all in the individual stocks we hold.

Where we do have conviction is in our disciplined process. Although it is admittedly unlikely, it's possible that the fund could look very similar to the Top 40 at times. If it did, it wouldn't concern us any more than it does when the holdings are completely different.

That's because we have no emotional connection to the portfolio's actual makeup. Companies move in and out not because we like or dislike their prospects. They do so because the model we have built tells us that they should.

Understanding our biases

To some investors, this is an anomaly. How can an asset manager have no conviction in any of the shares in their portfolio and leave the stock selection up to an algorithm?

The answer is that our approach has emerged from years of seeing how markets and investors behave and understanding our susceptibility to our own biases. And that experience has led us to believe that the best way for us to extract value from stock markets is through this systematic approach.

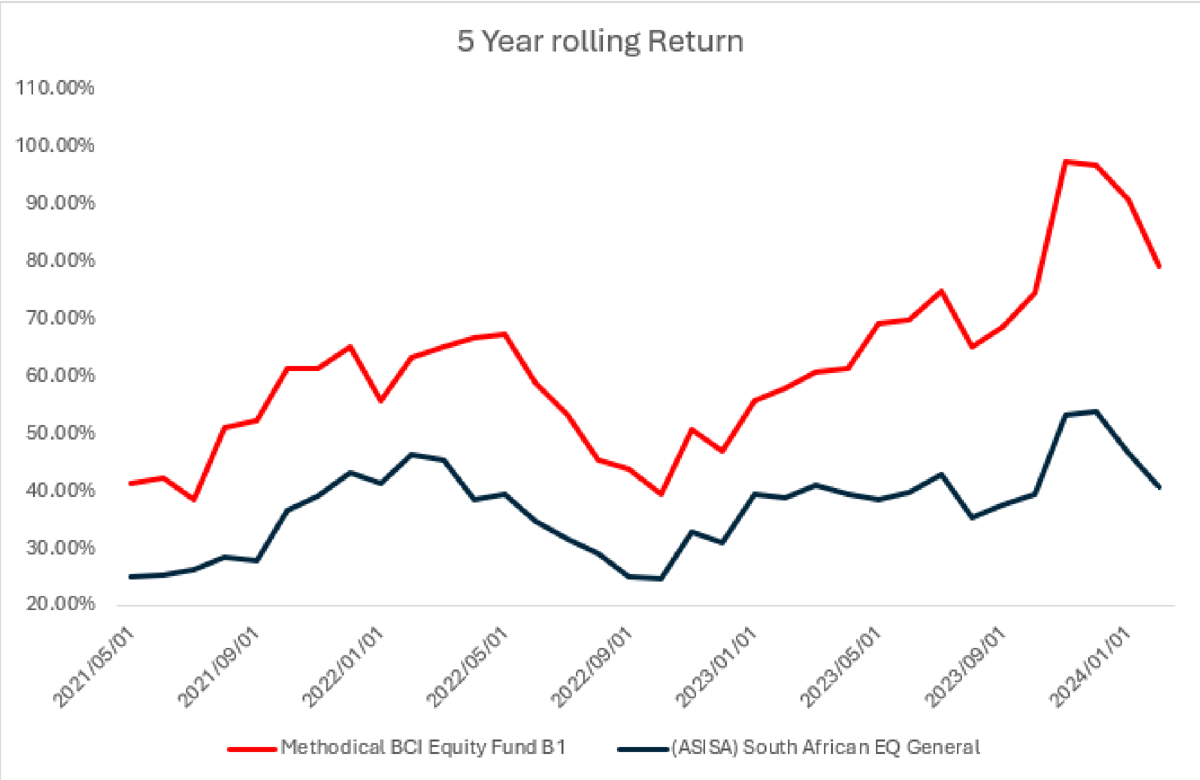
When we look back at the mistakes we've made in our own careers prior to starting Methodical, the worst decisions we've made have been because we moved outside of the guidelines we set ourselves. We didn't follow our own systems.

And often, we did that because we thought we knew better. We were so convinced in something that we believed the system no longer applied. And that's where decision making often falls down.

So, while we are not attached to individual shares the fund holds, we are highly confident in the systems we have built to identify which of them should be moved in or out of the portfolio.

We are still constantly monitoring, testing and finding ways to improve on it, and we always retain human oversight so that no decision is ever made purely by a machine. But we have a track record that shows that it works.

The graph below illustrates the Methodical BCI Equity Fund's five-year rolling returns relative to the South African general equity fund sector.



The beauty of our systematic approach is that it removes all of our biases and emotional states of being from the stock selection and portfolio construction processes. This is not a small matter. There is a large amount of research into how we are all affected by things we are completely unaware of when making decisions.

For example, a paper written in 2016 showed how hedge fund managers can be distracted by their relationships. It found that managers who get married or divorced deliver lower relative performance during the six months surrounding the event and for two years afterwards.

The managers themselves are unlikely to recognise that this is happening. However, their investment decision-making is being affected by something entirely unrelated, and that is something that a systematic approach allows us to avoid.

Market behaviour

At the same time, it also gives us a way to exploit other investors' behaviour. There is a growing amount of scientific evidence showing that humans repeatedly act in predictable ways, and this plays out in stock markets all the time.

The particular behaviour we tap into at Methodical is that when a share price moves up, that attracts attention. This leads to more investors buying that share, so the price moves even higher.

This is the simple premise behind the momentum factor in markets: shares that have performed well in the recent past are likely to perform well in the near future. We have built a systematic process that identifies when this happens and adds those shares to the portfolio.

We don’t need to know anything about those companies or have any conviction in what they do or how they do it. We only need to know that this behaviour persists, and that we have built a model that effectively captures it. After years of working on our system, we believe we have done just that.

Ross Reuvers & Edo Brasecke are the co-founders of Methodical Investment Management.