Key Questions

September 28, 2020

Why Is Conviction Key?

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The odds of favorable outcomes typically improve when investments are made with conviction, resulting in success over the long run.

Character, collaboration, consistency, and conviction: these four foundational principles of our investment philosophy are linked by putting clients first, our North Star. Of these four, consistency and conviction are most closely connected.

Consistency refers to adhering to carefully crafted and repeatable processes that inform our work. Just as a skilled surgeon, an experienced engineer, or an accomplished musician does in her/his respective craft, skill and proficiency are developed by applying established methods in a disciplined and consistent manner. Once these skills are obtained, a sense of conviction often materializes.

Through conviction, the ability to make sound decisions — minimizing the role emotions and biases can play when doing so (especially during times of volatility) and recognizing one's own fallibilities — typically improves the odds of favorable outcomes, resulting in success over the long run.

In response to the 2001-02 recession, US interest rates were kept low in hopes of stimulating demand. Policymakers went even further with their pledge to keep interest rates low for a prolonged period. At that time, it was a rarity for officials to make such forward-looking promises.

Following a few years of negative returns, stocks posted outsized gains in 2003 and double-digit returns in 2004.

As broad markets continued their ascent in 2005, real estate-related stocks were the belle of the ball. These equities soared 25% that year and meaningfully outperformed the broader market in 2006 with an even more impressive surge of over 31%.

It was around this time that I met Judy. Judy was a walking contradiction. Bespectacled, bookish, and barely five feet tall, you could easily mistake her for a reserved individual. Two minutes into a conversation, however, you quickly realized that her outward appearance bore little resemblance to her true self: possessed with a quick-witted personality and raw intelligence, she talked with assured, plain-spoken frankness. A portfolio manager of a highly respected investment management firm, Judy generated positive returns when most stocks suffered during the recession, which solidified her reputation as a shrewd stock picker.

From 2003 and 2006, however, Judy's results relative to her benchmark languished. Initially, performance matched that of her benchmark — a good outcome but somewhat pedestrian compared with her results from years past. But in 2005 and 2006, Judy's performance trailed that of her benchmark by a substantial amount.

Clients who had trusted Judy with their investments began to question her abilities. Some closed their accounts without hesitation. Admittedly, I had considered doing the same.

Before doing so, however, I paid Judy a visit. Before the meeting, I carefully dissected Judy's portfolio and analyzed the performance of each investment within her fund. In doing so, I realized that Judy's portfolio did not hold a single real estate company, despite the fact that these companies comprised nearly one-third of her chosen benchmark. This analysis formed the basis of our discussion.

When I met with her, Judy explained that she felt that she had no edge with which to evaluate these companies. Thus, without any unique insights, she chose to focus only on companies in which she had conviction. Interestingly, many of these “Judy stocks” had all performed sufficiently well. But because of the large sector concentration in real estate that existed in her benchmark and as a result of the sharp outperformance by real estate-related companies in general, Judy’s relative performance suffered. Otherwise, her portfolio was sound.

Armed with this information, I informed Judy that my investment in her fund would remain and concluded the meeting. In thanking me for my confidence, she offered one other admission: the week prior to our meeting, she and her husband took out a sizable second mortgage on their home and invested all of the proceeds in her fund alongside my investment. Her conviction could not be more tangible.

The following years saw the end of the real estate boom, and stocks in this sector fell 25% in 2007 and then 40% in 2008. While Judy’s portfolio was unable to preserve its streak of positive gains, it fell a mere 4% in 2007 and less than 10% in 2008. Her conviction was rewarded.

Today, the same circumstances are seemingly present, namely substantial outperformance by a small number of stocks relative to a vast number of others. Notably, these winners possess strong balance sheets, higher levels of profitability, and above-average competitive positions that in some instances have only grown wider since the advent of the COVID-19 crisis. Still, many investors know this, and thus many of these winning stocks also trade at substantially higher valuations.

For these reasons, we remain biased toward owning high-quality companies — including some of the perceived COVID beneficiaries — and advocate selectivity. But we further believe that active management merits consideration rather than allocating exclusively to passive capitalization-weighted indexes, and we hold conviction in owning more stocks than merely those that are most loved.

For more information, please contact your Key Private Bank Advisor.

Publish Date: September 28, 2020