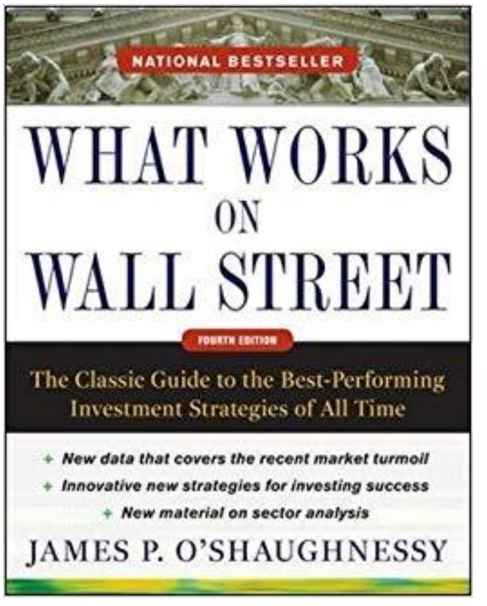
BLUE ALPHA
INVESTMENT MANAGEMENT

# RECOMMENDED READ: What Works on Wall Street – by James O'Shaughnessy




O'Shaughnessy cautions against stock picking, arguing that our decisions are vulnerable to many biases - particularly from the "noise" surrounding individual stocks. Instead, he argues for a rules-based investment strategy built on a defined process. He emphasises the benefits of being able to test a hypothesis; which can either be proven or disproven; but also highlights that implementing a rule-based approach assists the investor in staying the course and developing discipline around their investments.

The book consists of several studies done across a wide range of observable market metrics. This itself is the first lesson - for investors to develop the habit of consulting the evidence first, before placing too much weight on "common investment truths".

For example, many investors believe that small cap stocks will provide better returns than large caps over the long run. However, the evidence presented doesn't support this belief, which is further eroded due to small caps' generally higher risk metrics and lower liquidity. Therefore, investments into small caps warrants careful consideration. The evidence does however point out that the mid-cap range, just outside the area of analyst coverage can of offer a more accessible avenue of improving returns.

When investors are in search of value opportunities, the price-to-earnings ratio is often quoted as a determining factor for investment. O'Shaughnessy shows that while the thinking is correct behind this strategy, the approach can be improved. Through a series of studies, it is demonstrated that considering a company's Enterprise Value (net debt plus market cap) as opposed to only equity value, improves the results significantly. Returns are further enhanced by assessing EBITDA or Cash Flow instead of Earnings (EPS).

All investments are affected by the prevailing macroeconomic conditions and resultant cycles – some more than others. These cycles can help or hinder an investment strategy, sometimes for decades, only to underperform when the conditions turn against them. The last 10 years of loose monetary policy is a perfect example of this. Record-low interest rates over this period have provided strong support for equities. As rates normalize over the coming years, it is likely that the strategies that worked best over this extraordinary period may not be the most suited for the environment going forward.

So, while we cannot predict the best strategy for the next 10 years, we can use the same rigor demonstrated in this book when investigating which strategies will outperform in future. O'Shaughnessy's argument for a defined process and appropriate strategy is a useful roadmap for all investors in avoiding the pitfalls of emotional decisions, better equipping them to ignore the "noise" and achieve superior investment returns.