

A behavioural-based framework for understanding markets and price behaviour

Markets Evolve Through Be

■ Alexandra Rhiner, appunto communications, Glattbrugg

With her book «The Theory of Wild Beasts: A Framework for Understanding Price Behaviour» (2001), Kathy K. Sato has done pioneer work in developing and promoting a new way of investing. It is called «phaseinvesting», and it is a behavioural-based approach to constructing absolute return portfolios. «denaris» interviewed her about this concept and wanted to know what the phase framework offers that other approaches fail to achieve.

Now that the Efficient Market Hypothesis seems dead, would you say that portfolio management is undergoing a revolutionary change?

The portfolio management industry is definitely undergoing a revolutionary change. The year 2000 forced many investors to question a number of basic investment ideas. Take the buy-and-hold strategy as an example, or investing relative to a benchmark. This latter idea worked well as long as markets were rising. However reality hit when investors realized that a 500 basis point outperformance is still a painful -15% when the benchmark loses 20%.

These realizations forced investors to ask some very basic and practical questions such as: how can one construct absolute return portfolios when faced with a mind-boggling array of investment choices? The Efficient Market Hypothesis sheds very little light as to how one can approach this problem. The reason for this is that it lacks real world relevance. This is where the Theory of Wild Beasts is different. The Theory of Wild Beasts is a framework that helps us to understand markets and price behaviour. It strives for realism by embracing a very pragmatic stance on things like

the complexity of markets, i.e. the dynamics evolving out of the coming together of many, different, intelligent, adaptive, subjective agents. Some things that the Theory of Wild Beasts does differently is that it recognizes that financial economics is a different kind of science than the physical or natural sciences, and therefore a more appropriate philosophical basis and a totally different set of theory building tools are needed. Unsurprisingly these steps lead to a radically different, but commonsensical set of concepts as to how one should invest.

You mentioned the complexity of markets. Could you provide some examples of this?

One of my favourite examples is the «I think, you think, we think, that they will think that we think» phenomenon. This means that ultimately it is the subjective expectations of subjective expectations of others, which will effect how investors act. Another good example relates to the self-referential nature of markets. By this I mean that as market participants come together, they will, then and there, through their combined actions, create the market, which they are all ironically designed to exploit. Each investor will leave his imprint.

Theory is no doubt interesting, but the real challenge comes in implementation. What is phase-investing? And how does it work?

Phaseinvesting is the practical extension of the Theory of Wild Beasts. It is an absolute return portfolio construction methodology that seeks to exploit broader market trends by simplifying market complexity through a behavioural-based framework.

Unlike other approaches, phase-investing begins by applying a different definition of risk. Think about markets for a moment. Over time, markets evolve through different market or investment phases. During these phases, different investments will tend to perform well. Therefore the obvious thing to do

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is to take advantage of the most attractive market opportunities being offered by the market, while avoiding unwanted risks. The idea is to actively deal with the dynamics of markets. The critical question is naturally how?

Forecasting has long been a favorite approach. However, what has become apparent over time, is that regardless of experience, no investor can consistently predict the following year's top performer. Phaseinvesting gets around this issue by applying an «acclimatization» process. In the same way that the weather determines what we wear or how we dress, the market environment should dictate investment selection, as well as the structure of an investment portfolio.

How would one acclimatize a portfolio?

Acclimatization involves matching relevant investment opportunities to the prevailing market phases. The Theory of Wild Beasts provides us



Kathy K. Sato, Chief Investment Officer, Phase Investing Technologies, Inc. and Head of Portfolio Management, KMS AG

behavioural Phases

with hints as to how this alignment process might work. Markets as we know are ultimately a function of the actions of investors. These actions are a function of a set of core behavioural drivers. «Learning» for example is one of the core behavioural drivers. When investors are «learning», markets then exhibit «learning» behaviour as observed in trending prices. Conveniently, investment opportunities can as well be categorized by their defining behavioural driver.

Take a commodity trading advisor (CTA) as an example. A number of CTAs are trend-followers. They are not concerned about what asset class they invest in, rather their preoccupation is in exploiting trending patterns, i.e. in exploiting «learning» – and thus they are «learning» investors. Therefore in a «learning» phase one would acclimatize by focusing on «learning» opportunities, like trend-following CTAs.

How many behavioural drivers are there and why the focus on them?

There are five core behavioural drivers. They are learning, perplexity, surprise, discovering, and contentment. However, when it comes to return generation, the two most important are learning and discovering. Now, the wonderful thing about behavioural drivers is that they capture the humanness of markets. They are always relevant, unlike other fundamental factors which come and go in

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importance. The drivers are also characteristically distinct – in other words they create different return/risk-of-loss environments – just com-

pare trending, i.e. «learning» markets to sideways moving, i.e. «discovering» markets. Which environment has the more attractive risk/return profile? Finally behavioural drivers serve as a unifying perspective that simplifies the investment universe into manageable dimensions thus easing the allocation problem.

In what ways is phaseinvesting different from traditional approaches to portfolio construction?

The key difference is its phase orientation, i.e. how risk and return is seen in terms of the dynamics of market phases. Once the investment phase is identified, it dictates the broad structure and composition of the portfolio. Also no forecasting is applied. In the alignment process, the focus is not on asset classes, but rather on investment styles. Then top all of this off with best of manager/product selection, and one has an effective phase-dependent, absolute return portfolio construction methodology that systematically focuses on

key sources of return generation. I might add that phaseinvesting is not limited to hedge funds. It can accommodate a wide spectrum of investment tools. After all, there will be times when investing in mutual funds or index funds will do.



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Do phase-related investments already exist and what can you tell us about their performance?

In the past, the emphasis has been on managed accounts accessible to institutions and private investors with institutional needs. The performance here has been very good. To accommodate other investors, a new fund called GRIPS Absolute has recently been launched. The fund is managed by Hauck & Aufhäuser, advised by KMS Asset Management, and it is based on the phaseinvesting approach.

Nature adapts to changing seasons. Similarly, portfolios can be acclimatized to evolving market climates.

Origins of the theory's name

Kathy K. Sato's behavioural-based investment framework was initially called «The Theory of Wild Beasts, Gentle Lambs and Playful Trout» – too long a name for anyone to remember – but a name that exactly describes the essence of market price behaviour that conventional theory fails to capture. Her book provides an excellent introduction to these «wild beasts» (by greatunpublished.com, 2001).