

# Speculation

## Its Nature and Implications for Portfolio Management

*by Russell J. Morrison*

Two conditions are necessary for a potentially worthwhile speculation. First, one must have an idea of how others view the security in question. Second, one must disagree with their view. The more nearly the views of other investors approach a consensus, the more chance one has for developing a basis for valid disagreement.

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## Its Nature and Implications for Portfolio Management

This article is mainly an extension of some of the observations made in an earlier article titled "Musings of a Portfolio Manager" (May/June 1975). That article conceived of a portfolio as a diversity of ideas (speculations) finding expression in holdings of securities, non-holdings of securities, and cash.<sup>1</sup> It suggested that the portfolio manager's ultimate objective is to achieve the best possible total return by combining speculations in holdings with an average "investment quality" and with sufficient diversification to produce an appropriately reliable "bottom line" volatility—i.e., to produce the desired *investment* result. And it argued that the client, and not the manager, ought to determine the permissible character of that volatility.

A speculation in a securities portfolio is a judgment that one has found an inconsistency in market prices that promises a higher total rate of return and/or reliability of return than other apparent inconsistencies promise. The essentials of a speculation are alternatives, perceived price inconsistencies, faith that inconsistencies tend to disappear, and an idea of the uncertainty or risk surrounding the judgment.

That a judgment is worthwhile cannot, at the time, be known with certainty. Neither is it possible, objectively, to distinguish good luck from good judgment, or bad luck from bad judgment, even af-

ter the event. Admittedly, some of the ingredients for good judgment can be defined. Nevertheless, success or failure of judgment is properly measurable only in statistical terms. The more decisions made and the greater their variety per unit of time, the shorter the period required for judging portfolio performance. Time can be measured either in terms of months and years or in terms of numbers of decisions. In modern portfolio theory too much is made of time in the first sense and not enough in the latter sense. The distinction has implications for both portfolio performance measurement theory and the concept of diversification.

"Whether" there is a price inconsistency is a more important question than "when" an inconsistency will be closed, in part because it is usually the easier question. Good ideas have a way of "proving out" well within one's time horizon. Ideas usually reflect in part the world "outside," which is raw material available to other participants, hence likely to be conceptualized and acted upon sooner than one might expect. Normally, there is little reason for great confidence in the timing with which a particular speculation will prove out in terms of days, months or years.

"Random walkers" take the position that, with respect to total return forecasting, there are no grounds for believing that a single participant can be reliably successful or, by implication, unsuccessful—i.e., can expect to enjoy abnormal returns either higher or lower than any other participant. As evidence, they note that professionally managed funds such as mutual funds do not as a group perform better than "the market." The "Musings" article noted that this observation reflects the in-

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1. Footnotes appear at end of article.

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herently zero-sum game nature of markets with respect to *relative* price changes, with *leakages* from the game taking the *form* of transactions costs, administrative costs and costs of maintaining the "rules of the game." That the "game" is inherently zero-sum does not imply that all factors bearing on prices are already reflected in current prices—i.e., that markets are efficient. "Zero-sum" merely recognizes the obvious fact that all securities must be owned by someone.

Random walkers, as well as many of traditional stripe, err when they forget that reality does not consist solely of what is "out there." Rather, reality consists of what is "out there" plus what is "in here," i.e., what the mind of each participant contributes to understanding. For this distinction between "in here" and "out there" to be valid, the speculator must contribute an input, or an insight, which is proprietary. Otherwise, the individual is not a perceiver, conceiver, or even a participant. He is merely as a calculator is to the operator, or as a weather vane is to the wind.

### The Proprietary Position

I am reminded of *The New Yorker* cartoon showing a man in a telephone booth looking out at Fenwick Chemical's plant on fire. He is saying to his broker—"To hell with a balanced portfolio. I want to sell my Fenwick Chemical and sell it now." This fellow had a proprietary position with an excellent chance for a worthwhile financial result, provided he would not be deemed to be an "insider"; Fenwick Chemical was underinsured; the plant was an important profit center; and the share price had not already plunged. At that moment his judgment related to none of the usual analytical considerations except whether news of the fire was already impounded in the share price. Even in this simple case, judgment is required. It is uniqueness of viewpoint that is the mark of a proprietary position. The Rothschilds' homing pigeons carrying news of the outcome of Waterloo helped to produce a proprietary position.

Two conditions are necessary for a potentially worthwhile proprietary position. First, one must have an idea of how others view, or perceive, the situation. What are the various operative rationales bearing on, and determining, price? Second, one must disagree with the *balance* of the rationales by believing it to be wrong—wrong as to direction or wrong as to strength as reflected in current prices.

At any moment there is a variety of rationales that "explain" prices for the various participants in the valuation process. Generally, the narrower the spread of the rationales—the more nearly they approach a consensus—the more chance there is to

develop a valid and fresh rationale.

It must be admitted that one can have a fresh rationale that is the product of dementia; is wrong; is made to appear to be wrong as some new factor enters the situation; or appears to have been valid only because some new factor enters the situation. Thus *freshness* of viewpoint is *necessary*, but not sufficient, to establish a *valid* proprietary position.

A move in relative prices in the direction suggested by the valid proprietary position tends to *neutralize* that position. It is necessary to monitor *both price relationships* and the *rationales* underlying *price relationships*.

A single security can at any point in time be an outlet for several fresh viewpoints. For example, Alcan Aluminium Limited can be viewed as a means to exploit rising energy costs because Alcan's energy costs are largely fixed and/or because its products are worth a premium owing to their lightness. Aluminum can be viewed as a plastics or a copper substitute. Indeed, if these other materials are to rise in price as a result of higher costs, or temporarily for cyclical reasons, Alcan "becomes" a plastics or copper producer. It can be bought as a short on the Canadian dollar. It may also be used by its non-inclusion (or shorted) because it is the current rage on all of the above points and others, with a share price to match.

Philip A. Fisher describes and explains his techniques for generating proprietary positions in his *Common Stocks and Uncommon Profits*. In the main, they consist of his own intensive research into management characteristics. He reasons that in the long run a good management will keep the company in lines of endeavor that will provide opportunity for growth. Finding and monitoring exceptionally competent managements is his specialty. He includes in his work discussions with customers, competitors, former employees, banks, and corporate officials in an attempt to identify a mix of characteristics that promises good results in the long run.

To the extent that Fisher specializes in United States companies, particularly those in fields of high technology, it may be surmised that he has little use for the concept of broad diversification that many managers are required to employ, especially for portfolios that require high liquidity and close tracking with some universe of securities.

For the portfolio manager requiring these characteristics, a proprietary position can consist of a clear idea that one *cannot* generate a conviction on an important question. For example, if one is unable to maintain a conviction that his domestic currency is going to rise (or fall) on the foreign exchanges, he might alter the mix of holdings so that

any change would have less impact on the "bottom line." Thus diversification—in this case intentional contradiction—is built into the mix.

### Some Examples

It is noteworthy that the following examples of opportunities are simple. They go far beyond financial analysis. They can be considered within the pale of *securities* analysis only if that concept is broadly defined. (What a shame that our Federation is of "Financial Analysts"! "Securities Analysts" would be narrow enough.)

Mount Isa Mines Limited in Australia, then mining and concentrating 4,000 tons per day of lead, zinc, and silver ore, had discovered as early as 1953 over 300 million tons of 3.5 per cent copper ore in close proximity to current production. The site in Queensland was served by narrow-gauge rail from Townsville, 625 miles away. This rail line also served the 1,500 t.p.d. Mary Kathleen uranium mine. The line was fully utilized in servicing these two facilities and their infrastructures. It was the bottleneck and legally was independent of the Company. The shares of Mount Isa were priced *as if* the copper ore were not relevant. Buying Mount Isa was to buy not only an existing mine and a copper orebody; but a railroad expansion to come at zero capital cost. The market price of Mount Isa appreciated substantially when the railroad expansion came into view by early 1958, perhaps laying the way for plans for mine-mill expansion as well as for a smelter.

Banks in Japan were under official instruction to bring their financial reporting into conformity with uniform standards during the period March 1967 - March 1970. For many years, all banks had been allowed to pay dividends of up to ¥ 4.25 per share per year and all of them did so. Banks, good, bad and indifferent, had all for many years been priced by the market pretty much as if they were preferred stocks—i.e., to yield just under five per cent in the summer of 1968.

The "best" banks were doubtless understating earnings (¥ 25 to ¥ 30 per share were being reported) in terms of the new standard, while the "worst" banks were probably reporting earnings quite fully. For example, the equity of one of the best banks, even as late as August 1968, was priced at under the equivalent of \$200 million. At the time, total assets were shown at about \$8 billion, of which about \$350 million at cost was in the shares of Japanese companies. Market value of these shares could well have exceeded \$1 billion as most of them were acquired more than a decade earlier. Only a rise in interest rates could cause appreciable loss. On the other hand, once the various

banks' financial reporting became comparable, a new basis for determining permissible dividends would probably emerge, reflecting differences in the stature of the various banks. The time horizon for this did not extend much beyond March 1970—the deadline for uniform reporting. As it turned out, share prices of banks, especially the best banks, began to move up mysteriously in the September-December 1968 period and then to move sharply upward through 1969 and in 1970—in some cases to over ten times their levels of the summer of 1968. The thesis came broadly into the open only in January 1969, although it may have been percolating in late 1968 (when share prices of banks were rising with the rest of the Japanese market even though interest rates were not falling).

Products with magical qualities can produce periods of mounting and cumulative enthusiasm manifested in the market prices and trading volumes of the securities involved. Most enthusiasms go through a sequence of stages. We forget that in the early stages most people wondered who would want to use a mechanism that reproduced sound at the end of a wire. Plain paper copying? Big deal! Don't we already have typists, diazo, carbon paper, printing? Velcro in the mid-1960's? Don't we already have glues and screws, hooks and crooks as well as rivets? But this is magic, my friend! The magic fades only when pushed to the ridiculous. Recognizing enthusiasms in their waxing, aging and waning phases can be important.

It is interesting to note in the above examples that sensitivity to sequence is important. Exact timing is quite unnecessary. The Mount Isa Mines case entailed "seeing" a railroad expansion as a prerequisite to development. The Japanese bank case was based on the idea that rationality would replace seeming irrationality as to allowable dividends, once financial reporting was rationalized.

When is the price of magic too high? There are symptoms of "too high" that can be unrelated to *financial* considerations, including price. The examples all required *financial* analysis as one aspect of reaching investment conviction, but only of "back of the envelope" complexity and sophistication. All examples required *securities* analysis—broadly defined.

### Reflections on Modern Performance Measurement Techniques

Modern portfolio theorists for the most part require a defined universe of securities as a basis for measuring performance and for rational portfolio construction. Unfortunately, if one chooses to view a portfolio as the combination of a variety of ideas,

the universe of each portfolio manager is unique. The universe is his private field of knowledge and conjecture. Boundaries are fuzzy since no one can define what one "knows." Over any period, one's universe shifts because his expertise is both developing in some directions and decaying in others as he economizes his energy against the background of a changing world.

I submit the following outline of a time-honored performance test which is out of vogue with today's portfolio theorists, but which is consistent with the concept of the portfolio as one of ideas and only incidentally of securities holdings. This test does not require the concept of a defined universe, although I have no quarrel with using a defined universe as a basis for defining permissible portfolio volatility characteristics.

Given the volatility characteristics of the portfolio, this test asks whether changes in holdings have on balance improved or hurt the bottom line result. One should first track actual performance using a unit value concept to adjust for additions or subtractions of capital. This can be done at year ends, quarterly, or even at market highs and lows.<sup>4</sup> In any case, the idea is to develop many readings.

One then asks, "Would the fund be better off or worse off, if no transactions had occurred?" Taking the actual portfolios of, say, December 31, 1970, 1971, 1972, etc., one asks how these "unmanaged" portfolios would have performed by subsequent dates. Using only five year-ends of data, one can generate ten readings of unmanaged results; four are for one-year periods, three are for two years, two are for three years and one is for four years. With six dates, the number of possible readings increases to fifteen. These unmanaged results are then compared with the managed results. This technique does not require adjustment for risk differences between the portfolio and some universe of securities or group of deemed competitors because the game is "beat your former portfolio."

Not all comparisons will be of equal significance. Thus, year-to-year (let alone quarter-to-quarter) comparisons may not be as valuable as those for two- or three-year spans. The four or five comparisons ending on the most recent date should be given greatest weight. The one-, two- and three-year comparisons ending several years ago ought to be played down.

The significance of these comparisons is greater if turnover is high rather than low. The number of transactions should be sufficient to provide a reliable and objective basis for judging decision-making skill. Comparison of portfolio results with some standard other than former portfolio results

provides only indirect evidence of decision-making skill. Although such comparisons will reflect judgments that do not result in transactions, if no transactions are made in a period, there is no direct evidence that intelligence was applied in that period, hence no direct evidence of skill.

Significance is also greater if holdings are broadly diversified by legal status (bonds, preferreds and commons), industry, geography, political jurisdiction and "investment quality." Again, significance is greater if the period is not one of great turmoil in financial markets that moves prices in one direction leaving them vastly changed, either up or down. Comparisons for "up" periods should be balanced against those for "down" periods.

All measurement techniques contain a bias against those managers forced to sell portions of holdings that advance in price until they violate understood portfolio terms of reference. Gains of over 100 per cent are possible, but losses of over 100 per cent are not. For example, it would be difficult to beat your former portfolio in the six years ended December 31, 1965, if a full position in Haloid Xerox was held at the beginning of the period and the subsequent rise in price dictated sales during the period.

#### **Implications for the Concept of Diversification**

Conceiving of a portfolio as a diversity of speculations, including both holdings and non-holdings, has implications for the concept of diversification. Traditionally, diversification of a common stock fund has emphasized considerations such as the number of holdings, number of industries, geographic-political spread, variety of exposure to interest rate and foreign exchange rate changes, and the range of investment quality.

Modern portfolio theorists work from the limit where all securities in a defined universe are represented ("perfect" diversification) toward a conceived "efficient" portfolio. The make-up of the derived portfolio reflects the manager's total return forecasts for the universe as a whole, for a significant number of the individual securities in the universe, and for groups of securities classified by industry, or perhaps some other necessarily simplistic view of the world. Also required are mathematical expressions of the confidence that the manager has, or can have, in his various forecasts; his self-confessed trading costs; and permissible portfolio volatility in relation to the universe. When all of these factors are combined they generate a so-called "efficient" portfolio and an optimum turnover rate consistent with the input.

The "modern" theorist systematizes, and thereby

confines, in ways that a sophisticated traditionalist cannot tolerate.<sup>5</sup> The "nose count" approach to portfolio make-up in terms of numbers of securities, industries and relative sizes of holdings, etc., loses some of its appeal when total return, especially exceptional total return, is seen as a product of ideas, with securities becoming incidental. When total return is viewed this way, the manager prays for his sanity and energy and not for his securities. Hopefully, the manager ends up with a portfolio of ideas that is as effective in terms of objectives as he "deserves." A high level of sanity, a concept that includes recognition of one's limitations, tends to increase the number and diversity of ideas in his portfolio. On the other hand, a high level of sanity discourages impetuous, dilettantish trading—a condition that much of the financial community has an interest in fostering. It is a widespread modern naiveté to conceive of time mainly in terms of months and years, rather than in terms of sequence, the rate of generation of ideas, and the rate at which events occur.

Since each security normally represents a variety of themes, and since random selection of five securities in equal size from a universe of hundreds of securities yields about two thirds of the total diversification possible in terms of "bottom line" tracking over short periods, nose counts of holdings by number, by industry, etc., are less significant than is often believed.

Thus the concept of diversification should include not only nose counts of securities at each point in time, but also the number and variety of ideas represented by holdings and non-holdings. This thought was expressed obliquely by a colleague many years ago when he said, "We are a factory to produce ideas." When one shares his view, a portfolio can be seen as process, rather than as a static entity that merely happens to have a different composition at different points in time.

At any given time the manager will normally be running with an exceedingly large number of ideas expressed in both holdings and non-holdings. The more energetic the manager, given his level of sanity, the larger that number will be, because each security can represent a number of themes (or ideas) continually in a state of flux—of conception and destruction, growth and decay.

Some theorists claim that it is unfair, as a statistical matter, to judge "bottom line" results in less than five years—and perhaps not even then.<sup>6</sup> All managers are anxious to show how they have changed style, organization and/or personnel when time is up and results are found unsatisfactory.

Assuming that five years is an appropriate span for judging, many managers are tempted to say that they have a five-year horizon—which they presumably mean *as a limit*. In this case, the average

horizon for the portfolio is really two and one-half years. The impact of ideas should show up in *investment* results even sooner if one weighs the near future more heavily than the distant future and if there have been a significant number and variety of transactions.

If a manager and client can share the above concept of diversification over time ("serial diversification") and the technique of performance measurement outlined above, then generally they need pay less attention to portfolio betas (short-term tracking with some universe of securities), or to comparison with deemed competitors.

The manager can contribute to the client's benefit and his own when he demonstrates intellectual honesty, energy and keen insights and thereby earns the right to appear to be wrong, or in fact to be wrong, for longer than would otherwise be the case. One would not wait for five years of "bottom line" results to fire a manager who says that he bought International Nickel because it makes better automobiles than General Motors. ■

#### Footnotes

1. It is possible to conceive of a portfolio consisting only of non-securities if the scope for a manager is severely restricted. For example, if a manager was restricted to owning shares of copper mines (or cash), then his ideas might result in an all-cash position. A hedge fund manager, or a manager with scope to write naked options, would not face this difficulty.
2. Transactions costs for the pricing system as a whole consist *only* of the returns of agents, or *quasi* agents, in the transactions process. Charles D. Ellis forgets this point in his article "The Loser's Game" (July/August 1975). Excessive trading costs of the "dumper" or "grabber" are picked up by the "dumpee" or the "grabbee," assuming dealer spreads are given.
3. Richard Decker; ©1957, The New Yorker Magazine, Inc.
4. Tracking performance at market highs and lows is to be recommended with caution lest the "name of the game" become "bet the market," which implies foregoing diversification unless decisions about "the market" are made frequently.
5. Whether modern portfolio theorists make a *practical* contribution to portfolio management might be tested by the following technique. Ask a number of managers at regular intervals (every month) to create their inputs at single sittings. I surmise that the changes in securities mixes that would be "thrown up" from sitting to sitting would usually be so great as to imply ruinous levels of transactions. Transactions should be limited in practice to reflect transactions cost estimates and imputed forecasting skill.
6. See Keith P. Ambachtsheer, *PMS Letter #21* published by Canavest House Limited. Richard Brealey and Stuart Hodges have also contributed to this area.