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The art and science of investment: Why process matters

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In the world of fund selection, picking funds is a blend of science and art. Every investor prioritises their research differently, but the most common framework involves the 4 P's: philosophy, process, people, and performance. Unlike the marketing mix of product, price, place, and promotion, this framework helps in assessing funds comprehensively. People and performance often weigh heavily in an investor's decision-making process.

A high-profile manager with a strong track record is an easy sell for any asset management company. Philosophy reveals the manager's fundamental beliefs guiding their decisions and helps investors distinguish between different investment styles. However, the investment process, which is sometimes overlooked, is crucial. We have invested a lot of time in developing our own process and analysing those of investment managers worldwide.

An established investment process is vital for mitigating emotional biases that often affect investment decisions. Behavioural finance has shown that emotions like fear and greed can lead to irrational decisions. A structured process helps investors remain disciplined and avoid impulsive choices based on short-term market movements. By sticking to a well-defined process, fund managers can ensure their decisions are based on analysis and strategy rather than emotional reactions.

Consider the 2008 financial crisis. Many investors, driven by fear, sold their investments at significant losses. In contrast, those who adhered to a disciplined investment process, such as Warren Buffett, who famously advised to "be fearful when others are greedy and greedy when others are fearful," made rational decisions that ultimately led to long-term gains. Buffett's commitment to his investment principles allowed him to spot undervalued opportunities during the downturn, demonstrating the importance of a solid investment process in countering emotional biases.

A robust investment process also promotes consistency and objectivity. Behavioural biases such as overconfidence, herd behaviour, and loss aversion can cloud judgement and lead to erratic decision-making. A systematic approach enables fund managers to apply the same criteria and methodologies to each decision, thereby reducing the influence of personal biases. This objectivity is essential for achieving long-term investment goals and maintaining investor trust.

Clear and transparent investment processes enhance accountability. When fund managers follow a documented process, it is easier to review and evaluate their decisions. This accountability ensures that each investment choice is based on sound reasoning and predefined criteria. Transparency builds investor confidence, as they can see that their money is being managed systematically, rather than being subject to whimsical or emotionally driven decisions.

Market volatility often triggers strong emotional responses, leading to decisions that may not align with long-term strategies. A disciplined process helps fund managers navigate volatility by sticking to their investment principles and strategies. This steadiness is crucial during downturns, as it prevents panic selling and encourages a focus on long-term value rather than short-term losses. Managing volatility with a structured approach enables fund managers to better protect investor capital and achieve more stable returns.

The impact of the COVID-19 pandemic on markets in 2020 underscored the importance of managing volatility through a disciplined process. Fund managers who maintained their investment processes avoided panic selling and instead focused on rebalancing portfolios and identifying opportunities in undervalued sectors. This approach helped protect investors from permanent loss of capital and positioned funds for recovery as markets stabilised.

The quality of investment decisions improves significantly with a well-defined process. Behavioural investing highlights how cognitive biases like anchoring, confirmation bias, and hindsight bias can distort perception and analysis. A systematic process involves rigorous research, data analysis, and adherence to investment criteria, leading to more informed and rational decisions. This disciplined approach ensures that each investment is thoroughly evaluated, reducing the likelihood of errors caused by cognitive biases.

In conclusion, a well-defined investment process is crucial for managing the behavioural aspects of investing. It should allow the portfolio manager sufficient freedom to implement their judgement, but it must also be robust enough to mitigate emotional biases, ensure consistency and objectivity, enhance accountability and transparency, manage market volatility, and improve decision-making quality. By focusing on a structured process, fund managers can achieve better investment outcomes and maintain long-term investor confidence.

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