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Gaining an information edge … then and now

Brandon Snow, October 19, 2018

Access to information is critical to gaining "an edge" when investing, helping us to avoid losses or generate gains. Importantly, the nature and source of this information has changed dramatically over the centuries – with the speed of change accelerating in recent times – alongside the investment industry itself. We now live in an age of ubiquitous, instantaneous access to information and computing power that has eliminated any advantage based on short-term processing of information.

So how do we currently gain an information edge? Our approach is multi-dimensional but relies on the basics. We recognize the inefficiencies of markets and use our fundamental analysis of companies to find value. We focus on buying a piece of a business rather than speculating on stock prices. We take our time on company due diligence and determine the price we're willing to pay, patiently waiting for any disruption that could provide an entry point at a discount to intrinsic value.

Certainly, in another time our investment approach and the idea of an information edge or advantage would have been entirely different, as the brief history outlined below shows. This historical context highlights many of the quirks and shortcomings of former practices, but ultimately reinforces why thorough investment analysis and disciplined primary research remain critically important today: **Given the pervasiveness of information, and the near instantaneous ability to analyze it, the skill of active management must come from deeper and longer-term thinking.**

Early days

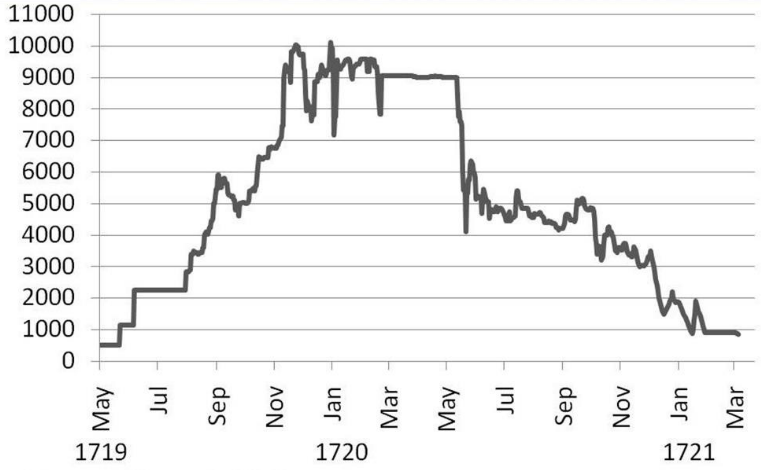
The concept of trading stocks (pieces of a company) began over 400 years ago with the advent of trading companies in the 1600s. These companies issued stock that would pay dividends on the proceeds from the sea voyages they undertook. For the first 250 years, speculators would meet in cafes and other public places to share ideas and identify potential business opportunities, but there were no audited financials, no regulations and no promises. The information was relegated to general knowledge of the business and what this community thought of it. As a participant, you could outplay your competitor, like in poker, or dig deeper to find specifics about the company. You could get an edge, but you couldn't trust all the data.

1700s: John Law and the Mississippi Company

One of the first major speculative bubbles involved the Mississippi Company, conceived and run by Scottish adventurer, economic theorist and financial wizard John Law. At the time, France, which owned territories in the Mississippi River valley of North America, was essentially broke. Law, who was a friend of the French regent, convinced the crown to give him the state bank and a monopoly on trade with French Louisiana, in exchange for taking on the government's debts. The bank took in coinage (gold and silver) in exchange for notes, which would benefit from the profits from trade with the new territory.

Law created promotional material describing the new region as the "Garden of Eden", creating a bubble in the shares.

Fig. 1: Mississippi Company Share Price



Source: Francois Velde

Of course, Law met this demand with newly printed notes. As speculation continued, paper wealth exploded: shares in circulation increased dramatically as did the company's share price. This led to a rapid inflation of goods, assets and economic activity.

Buyer beware: Asymmetric information

While Law managed to create the perception of riches and development opportunities in North America, the reality was far from the promise. By the end of 1718, only 1,600 Europeans had moved to the region, known as New France. In 1719, France allowed Law to forcibly send nearly 10,000 criminals, prostitutes, disorderly soldiers, unsuspecting peasants straying into Paris and slaves – not an ideal recipe for the success of a new territory. At the beginning of 1720, many investors tried to take profits, which could not be paid for with coinage. In May 1720, amid the pressure, the value of shares in the company dropped by 50%. By the beginning of 1721, the share price had fallen nearly 90%. Recognized as a charlatan, Law escaped France dressed as a woman by the end of that year.

1920s: The rise of price speculation

Fast forward to the 1920s, when there were organized exchanges, newspapers publishing prices daily and ticker tapes with a much shorter delay. Access to information was greater and investors could take advantage, albeit based largely on speculation. "An edge" could be gained through the speed with which you obtained the key piece of information for speculation: price.

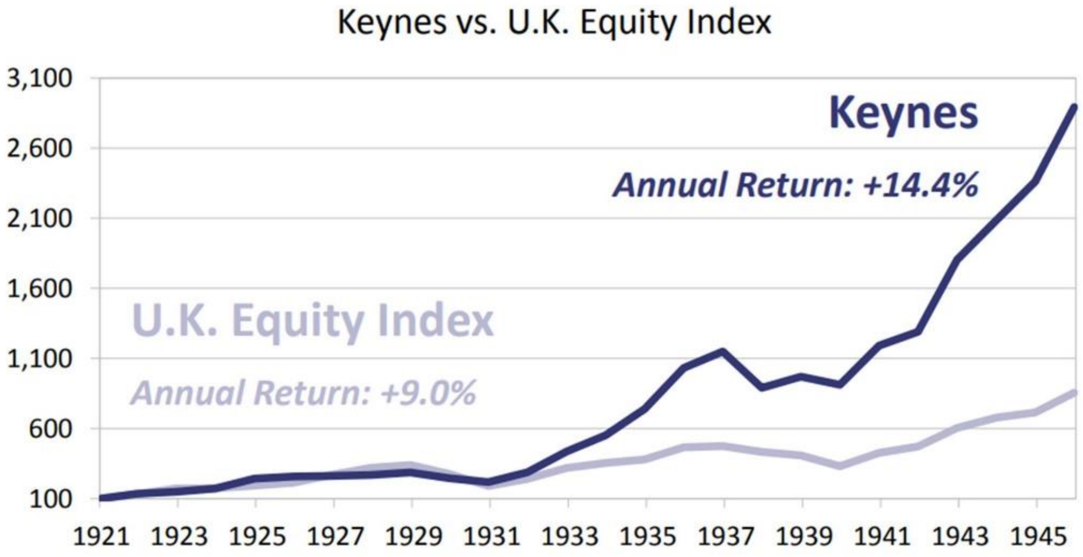
Most successful brokerages were stationed close to the exchange and the ones with the quickest "pad shovers" had an edge. Of course, the investments being made were mostly speculative, a situation that was heightened in the wake of the First World War and the economic imbalances between Europe and the U.S. (For a great review of this period I suggest reading *Lords of Finance, The Bankers Who Broke the World*, by Liaquat Ahamed).

1930s: All the way with JMK

After this period, a key insight into how to approach markets was provided by John Maynard Keynes in the early 1930s. The British economist had lost about 80% of his wealth during the Great Depression, which led him to develop a unique theory on speculation. Keynes described the action of rational agents in a market using an analogy based on a fictional newspaper contest, in which entrants are asked to choose the most attractive faces from a hundred photographs. Those who picked the most popular faces were then eligible for a prize. As he described in his book *General Theory of Employment, Interest and Money,* (1936):

> "*It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."*
>
> *"…it may often profit the wisest (stock market player) to anticipate mob psychology rather than the real trend of events, and to ape unreason in anticipation…Thus, so long as the crowd can be relied on to act in a certain way, even if it be misguided, it will be to the advantage of the better-informed professional to act in the same way…"*

After 1930, Keynes coupled his contrarian approach based on “the beauty contest” with bottom-up stock picking. This enabled him to achieve outstanding investment performance for nearly 15 years:



Data: *Keynes The Stock Market Investor*, David Chambers and Elroy Dimson, 2012

1950s: The era of fundamental analysis

Another key insight came in 1949 when the British-born American investor, economist and professor Benjamin Graham published *The Intelligent Investor*. Graham recognized that when you buy stocks, you are buying a piece of a business. You own part of the assets and cash flow stream of a company and by analyzing the financial statements (which had become available), you could own and participate in the value creation of a company. You no longer had to speculate, but rather you could invest!

The era of fundamental analysis emerged, and those willing to do the work and dig into regulatory documents could get a significant edge versus most other speculators. In fact, in the early 1960s, The Wall Street Journal published a list of companies that were what Graham called "Net-Nets" (i.e. when the shares in a company are trading below the value of their short-term assets less all their liabilities. In essence, you were buying a business for less than the value of its liquid assets). In 1964, the WSJ list consisted of 200 companies. By the early 1970s, this edge was reduced as more people followed this investing approach and were analyzing and acting on the available information.

As the investment industry developed, more brains were focused on analyzing this available information and the "cigar butts" – mostly smoked and discarded but with a few free puffs left – became fewer and further between, especially among larger companies. Your “edge” in this era would be sheer brainpower – the more knowledgeable your employees tasked with analyzing the opportunities, the more quickly you could identify these stocks and beat others to the punch.

1980s: Faster technology

In the 1980s, the investment industry really started mushrooming. The public was investing in stocks, and companies were investing in people and technology to gain an edge. The Quotron became the tool of choice to determine stock prices, eliminating the price delay from the exchanges or newspaper. The edge now entailed having more immediate access to prices. In addition, new technologies were used to access information earlier. Fund companies were acquiring fax machines, which meant accessing information almost in real time as opposed to relying on mail delivery. The edge was, in part, the ability to gain access to financial results days prior to the general investing public. What an edge at that time!

1990s-2000s: Improved disclosure

As technology made access to price and company information more ubiquitous, investors had to find new ways to gain an edge. Through the 1990s, one source was the management teams of companies themselves: investors would build a relationship with the management of a company, which would afford them unique information about the business, including strategy and trends. Only the largest institutional investors could obtain this access to every company. In fact, this edge existed in some form all the way until the early 2000s. After many abuses of this process, the U.S. Securities and Exchange Commission in 2005 introduced Regulation Fair Disclosure (Reg FD) to close any loopholes that had caused selective disclosure to become commonplace. From this point, it became commonplace for CEOs of large companies to rely on their General Counsel to ensure they would only say things that had previously been disclosed publicly. (Studies have actually shown the impact of these changes with alpha generation between large and small fund management firms converging post Reg FD).

How about today?
Today we have the benefit of being constantly connected through multiple devices and platforms. We have instantaneous and ubiquitous access to information. Moreover, more and more of that information is pushed to us daily through email, notifications, social media posts, text messages, etc.

But something sinister has happened: our attention has become a valuable commodity in this always-on world. All online companies (from trusted news sources, to Russian trolls, to click-bait) deal in the currency of engagement. Our time, our attention, our focus is the commodity they're mining. And what drives engagement isn't cold hard facts, nor objective analysis, but rather anything that causes a physiological or emotional response.

Over the history of investing, getting an edge on information meant either quicker access to information or faster analysis. In the world we're in, what gives you an edge? A BETTER FILTER!

The Cambridge Team remains focused on improving our information edge. We use technology to free up our time for more critical and creative thinking about the industries we cover and companies we invest in. By turning down the noise, we can remain focused on what matters in the long run: a business' ability to define and reinforce its competitive advantage.

Best regards,

Brandon Snow

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