You probably know the story of David and Goliath. A diminutive and wise civilian, David of Israel, volunteered to fight a giant undefeated warrior, Goliath of Philistine, in a one-on-one battle and defeated the giant using a slingshot, to the surprise of everyone present except himself.

This story is remarkable in several ways. It is an underdog story and since the underdog won, it makes people feel cheerful and optimistic, possibly even invincible, like there is no insurmountable challenge. It is a “brains versus brawn” story. David cleverly defeats Goliath using a slingshot from a distance, where speed and mobility are competitive advantages, instead of engaging in close-range hand-to-hand combat, where size and strength are competitive advantages. David probably observed Goliath slay brave but foolish Israeli warriors daily in close-range battles and figured that he should avoid situations that favor Goliath’s competitive advantages and seek situations that favor his own competitive advantages.

It is a story about conviction and self-assuredness. As it has been told, King Saul and the Israelites stood facing Goliath and the Philistines in the valley of Elah. Twice each day, Goliath would come forth and challenge King Saul to send his best warrior to fight Goliath one-on-one, champion-to-champion -- a spectacle form of psychological warfare, perhaps intended, that must have instilled fear in Israelites and boosted confidence in Philistines. But rather than intimidate David, it appears to have educated him about Goliath’s style of combat because David was not sent by King Saul to fight Goliath, he volunteered. Assuming David was an even-keeled man, such behavior is usually an indication of conviction and self-assuredness. Still, the Israelites (probably the Philistines too) must have thought David was insane or suicidal.

The story of David and Goliath is also about asymmetric incentives. On the one hand, Goliath had every incentive to fight Israeli warriors, champion-to-champion. The same could not be said of the Israeli warriors. Knowing cowardice meant death for treason and believing defeat by Goliath was inevitable, every Israeli warrior summoned by King Saul had no incentive to fight Goliath, unless you consider dying before a crowd a form of incentive. On the other hand, Goliath had absolutely no incentive to fight David. David was by all accounts a scrawny civilian, certainly not a warrior and definitely not a champion warrior. If Goliath defeated David, well, he was expected to win. If he lost to David, he was dead. David, however, had volunteered to fight, which meant that he was
not burdened with the horrible choices of death by cowardice or death by Goliath. He had every incentive to fight Goliath... life, victory, ending the battle between the Israelites and the Philistines, accolades, etc. Strange as it may seem, Goliath did not want or need David, but David needed Goliath. David’s success and the significance of the story depend on there being a Goliath.

Applying this story to the world of investing, David represents all professional value investors (though not usually value-style mutual fund managers) and Goliath represents all other professional investors. Professional value investors are in the minority among all investors and, more importantly, so are the beliefs or principles by which they invest. Here are some examples.

- Professional value investors believe that markets are inefficient pricing mechanisms and there is a difference between price and value, whereas other professional investors believe that markets are efficient pricing mechanisms that reflect all relevant information at all times keeping price and value the same, and therefore it is impossible to outperform the market. In other words, other professional investors believe in the Efficient-Market Hypothesis or “EMH”.

- Professional value investors believe that risk is not defined as volatility, but rather the possibility of a permanent loss of capital. Other professional investors believe that risk is defined as volatility, which are cornerstones of Modern Portfolio Theory (“MPT”) and the Capital Asset Pricing Model (“CAPM”). Price volatility can be a value investor’s friend.

- Professional value investors believe preserving capital (i.e. not losing money) is more important than growing it. Other professional investors believe pursuing growth is more important than preserving capital, or the potential for big gains in wealth are worth the risk of capital loss.

- Professional value investors believe that diversification is not an effective risk management tool and that it is better to own fewer investments and know them really well, whereas other professional investors believe that diversification is the key to managing investment risk and therefore it is better to own more investments that are sufficiently uncorrelated with one another.

- Professional value investors believe that cash has option value to an investor so that s/he is able to invest when opportunities arise and others cannot invest. Other professional investors believe in being fully invested at all times because cash is not part of an efficient portfolio.

Since professional value investors and their beliefs are in the minority, it should not surprise you to know that all of the beliefs held by other professional investors are considered conventional wisdom in the investment management industry. These common beliefs are primarily derived from the handful of theories and models already mentioned above (the EMH, MPT, and CAPM) which have been promulgated by distinguished
business school professors and Nobel Prize winners. However, it might surprise you to know that financial theories are subjective, meaning there are no proven laws in finance, and they have been disproven in practice. Further, MPT and CAPM are backward-looking and rely entirely on historical price data and statistical analysis to calculate estimated value, expected return and expected risk. At best, price data reflects historical investor behavior at various points in time, not the particular risks, nature or intrinsic value of a business or industry. Still, given their pedigree and devoted following, these theories and models remain the most widely taught and accepted set of beliefs on investment management in the world. I was taught them as an undergraduate and again as a graduate. The best thing I can say about them is that they helped me learn statistics.

In the minds of other professional investors, this widely held set of beliefs is considered a competitive advantage because it creates an information gap or asymmetry. The rationale is that there is strength in numbers and there is no sense in fighting Goliath if you don’t need to do it to survive. They exploit this gap in myriad ways. One way is to dazzle clients with trendy new products and terms like “active-alpha strategies”, “actively-managed ETFs”, and “alternative ETFs” with the dual expectations of appearing knowledgeable and getting more money from the client. This widely held set of beliefs and these tricks all fit nicely into an explainable theoretical framework which makes them both complex enough to ensure a client’s ignorance and easy enough to use as a seemingly objective, data-driven marketing tool to convince a client of an investment manager’s expertise.

The 15th century Dutch humanist and scholar Desiderius Erasmus of Rotterdam is credited with the Latin quote, “In regione caecorum rex est luscus”, which translated reads, “In the land of the blind, the one-eyed man is king”. In such a world, it would be important to know if the king is benevolent or malevolent. In my experience, most professional investment managers view investors as “the blind” and themselves as “the kings”.

Economist Steven Levitt, co-author of Freakonomics, wrote, “If you were to assume that many experts use their information to your detriment, you’d be right. Experts depend on the fact that you don’t have the information they do. Or that you are so befuddled by the complexity of their operation that you wouldn’t know what to do with the information if you had it. Or that you are so in awe of their expertise that you wouldn’t dare challenge them.” The investor-client information gap is a competitive disadvantage in my opinion because I believe there is a difference between trust and blind trust. One is durable and one is not.

Naturally, like David was perceived, professional value investors are perceived as the underdogs and other professional investors are perceived as the favorites because most of the world believes that it is impossible to beat the market. Incidentally, this world belief is one of two reasons why 31% of U.S. households that own mutual funds are passively invested in at least one index fund, according to the Investment Company Institute (“ICI”). The other reason so many assets are passively invested is that many investment
managers do not want to be evaluated on or held accountable for performance. They don’t mind volatility in your investments, but they do mind volatility in their paychecks.

Successful investing requires conviction and self-assuredness. Like David did, professional value investors develop conviction and self-assuredness internally and independently relying on their knowledge and experience. Like Goliath did, other professional investors borrow conviction and self-assuredness from the crowd instead of relying on their knowledge and experience. I believe that there is greater strength or competitive advantage to be gained from critical independent thought than from drinking at the fountain of conventional wisdom with one’s eyes closed. Again, one is durable and one is not.

Professional value investors often tell it like it is, are accountable, and construct performance-based fee structures that align incentives, eliminate asymmetric incentives and provide every incentive to perform for their clients. Too often, other professional investors obfuscate, not transparently disclose actual costs and fees, hide account activities, redirect accountability, and construct non-performance-based fee structures that take advantage of, and provide no incentive to perform for, their clients. In other words, too many other professional investors treat their clients like marks in a legalized scam instead of like… say… family. Under these circumstances, clients have every incentive to abandon the land of conventional wisdom and their other professional investors, but very few do. The fear of not being part of the “in” crowd trumps the fear of being a chump and losing money. I prefer to treat my clients as if they were family members, not marks. Yet again, one is durable and one is not.

None of this is revelatory. However, it might surprise you to know that the success of professional value investors, like yours truly, depends on the very existence of other professional investors and their predominant set of beliefs, like David’s success depended on the existence of Goliath. If the investment world were comprised of mostly professional value investors, my durable competitive advantages would be less potent and my job would be a lot harder.