PRO

Patrick O'Shaughnessy

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{ INTERVIEW BY KHAI NGUYEN }

Patrick O'Shaughnessy is a Principal and Portfolio Manager at O'Shaughnessy Asset Management (OSAM). Patrick is the author of Millennial Money: How Young Investors can Build a Fortune, published by Palgrave Macmillian. Patrick is also a contributing author to the fourth edition of What Works on Wall Street and the author of several market commentaries, including "The Same Old Bear" which earned awards from Advisor Perspectives for The Top 25 Venerated Voices™ by Author and The Top 10 Venerated Voices™ by Commentary. Patrick holds a B.A. in Philosophy from the University of Notre Dame and is also a Chartered Financial Analyst. He lives with his wife and son in Greenwich, Connecticut.

Khai Nguyen: I'm here with Patrick O'Shaughnessy, author of the book, Millennial Money: How Young Investors can Build a Fortune. Patrick thanks for joining me today.

Patrick O'Shaughnessy: I wish there were more long form interviews like the ones you conduct, so thank you for including me in your series.

KN: Patrick, your book has received excellent reviews. What inspired you to write the book?

PO: Do you know how there are some things in life you just feel natural doing? For me it's always been reading and writing. To write a decent book, I think you need to first read 300 to 400 other books, so I spent my early mid-twenties reading. When I was 27, I felt like I had accumulated enough knowledge to start writing.

Because I am young myself, I wanted to write a book addressing younger investors. They make an ideal audience for several reasons. First, they have such a long time horizon, so they have enormous investing potential. Second, the millennial generation has been underserved thus far by the financial services community. As a group, they haven't accumulated enough wealth to make them lucrative clients. They own just about 4% of mutual fund assets. Most financial authors are much older, so I thought I had a neat opportunity to appeal to younger readers. It has been a blast connecting with them. Thus far I've found that hearing from someone their age helps millennials get interested. Many that I've talked to have started investing sooner than they would have otherwise.

KN: How has the experience of authoring the book affected the way you look at investing?

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PO: Writing a book made me realize how little I know. As I read and researched more and more, the amount that I knew grew, but the amount that I didn't know grew even faster. For every question answered, three new questions popped up. Faced with so many questions and so little time, I've realized that investors simply can't know it all. Instead, I think it's best to identify areas where you have an advantage and stick to it. Sometimes simple rules—and investing strategies—work very well. I lay out five pretty basic attributes to look for in stocks in Chapter 6 of the book. They may not be the absolute best attributes, but they have worked very well. There is a common saying in the art world that "perfect is the enemy of good."If you try to get everything exactly right you'll never get anywhere. Trying to build a perfect investing strategy is impossible. This was a liberating realization.

KN: What was your earliest experience with investing?

PO: One of the first photographs of me as a newborn is of me napping, with a copy of the book "Stock Market Logic" laid across me as if I'd fallen asleep reading it. My father was experimenting with osmotic learning.

KN: Can you describe your investment style and philosophy?

PO: It is a very straightforward recipe. First, find the attributes shared by history's most successful stocks. Basically, avoid stocks with the worst balance sheets and suspicious earnings quality and buy those with very cheap current valuations, strong recent price trends, and high total yields. Second, build portfolios of stocks with similar attributes today. Third, rebalance to move the portfolio back towards stocks with these same attributes as market conditions change. That's pretty much it. The key is to never, ever deviate from this model and to keep doing it for a long time.

There is a lot of nuance in this approach—how to rebalance, how to calculate your factors, how in incorporate new and better methods uncovered in ongoing research, and so on—but the core philosophy is quite simple.The secret sauce of this style is persistence. If you use this strategy, you'll end up with a unique portfolio—one that will often look unappealing and have recent performance to match. The key is to not get scared out of the strategy when it is lagging, which it will from time to time. There is a lot of evidence that simple models are better than humans; be it in predicting wine prices or stock returns. But it is very hard to continue to trust a model when it isn't working. As such, I only recommend this type of strategy for those who recognize this fact and are prepared to stick with the model.

KN: Who were some of the people that influenced your investment style along the way?

PO: David Dreman, for his sharp insight into the power of contrarian investment strategies. Joseph Campbell, whose writing on mythology contains countless lessons for would be investing heroes. Daniel Khaneman and his various research partners, whose exploration of psychology gives me the comfort that our approach will continue to work in the future—because human nature doesn't change. Jiddu Krishnamurti who taught me the value of investigating for oneself and never simply taking someone else's word for it. Michael Mauboussin for his countless insightful papers. James Montier for the same reason. Philip Tetlock for curing me of any desire to forecast the future. Nassim Nicholos Taleb, Arthur Koestler, and Edward de Bono for building frameworks to help me think differently—although Taleb would probably not like my portfolio with its lack of disaster insurance. The authors of the Upanishads, for helping me stay calm. So many others! James O'Shaughnessy for too many reasons to list.

KN: You're a big fan of leveraging historical market performance patterns to invest. What are the advantages of using such an approach?

PO: For anyone trying to outperform the market—a less and less popular pursuit—it is very valuable to be able to test whether your strategy would have worked across a long period of market history. Having 50-80 years of data in which to test ideas is a luxury. I love the idea of value orcontrarian investing, but I like it a lot more knowing how well it has worked historically. Some things sound appealing, such as high sales growth for example, but work terribly. You'd want the lowest sales growth companies, if anything. Having the historical data allows us to weed out these bad ideas.

KN: Where do you see the most compelling investments in the current market environment?

PO: My answer is so boring because it's the same no matter the market: cheap stuff that isn't pure junk and that the market is just beginning to notice. Said differently, value and momentum, with some attention paid to avoiding the worst quality stocks. Markets are pretty expensive across the board in 2015, but there are almost always small pockets of opportunity, and these factors have proven to be the best ways to find those pockets.

KN: What are some of the mistakes you've seen investors make?

PO: Usually they are timing mistakes. They abandon a strategy right at its performance nadir. They invest in a stock or strategy after it has done really well, when they should instead be doing the opposite.

KN: In your book, you talk about the importance of Millennials to start investing and building wealth early. Why is this so important and where do you see the investment behavior of millennials trending?

PO: Returns in the stock market get much steadier the longer your time horizon. Stocks yield terrible results in some short term periods, but once you get to 30-40 years, they've delivered remarkably consistent and strong results. Stocks would be very risky for a 50-year old. They are much less so for a 22-year old. Time is a huge asset for millennial investors right now, so the key is reaching them young. If you are a parent or know a young person, please help set them off on the right foot!

Sadly, many millennials are already making common mistakes. In their portfolios, they are favoring exciting stocks that they know well—think Tesla, Twitter, and Facebook. But these stocks are very expensive and priced to do poorly. I wish they'd instead either index their money or focus on cheaper stocks, even if these cheap stocks aren't nearly as much fun. Now of course if all millennials followed this advice, the cheap stocks would no longer be cheap, but I am confident only a very small minority will do so.

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KN: Any advice you would give to professionals coming into the investment industry?

PO: Read nonstop. Never assume those in prominent positions know any more than the rest of us, although some do. Never forecast, you'll be wrong constantly and often immediately. Experiment with unconventional ideas. Realize that if you want to beat the market, you need to be very different from the market—otherwise you might as well just index your money. Follow Templeton's advice: don't ask where the outlook is best, ask where the outlook is miserable—you'll find much better opportunities there.

KN: What is your approach to introducing investing to your son?

PO: I'll give him a stack of 50 books—many of which will only be indirectly related to investing—tell him to read the 10 that interest him most, then read the 10 that interest him least, then we will talk about them!

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