

Does one need to carry out macro financial analysis?



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Should investors worry about the big picture when making stock-specific decisions? Or would it be better if they remain market-agnostic?

To explore these and related questions, we recently developed a new course at the Ivey Business School's Ben Graham Centre for Value Investing called "Macro Financial Analysis." And this course caught many value investors by surprise.

The reason is that long-term investors, such as value investors, argue that it is far more rewarding to focus on valuation and bottom-up analysis rather than the big picture – the state of the economy and that of capital markets in general.

To be fair, Ben Graham, the father of value investing, did not advocate that investors abstract from the big picture. He instead advised investors to "have an adequate idea of the stock market history, in terms particularly of the major fluctuations. ... With this background [they] may be able to form some worthwhile judgement of the attractiveness or dangers ... of the market."

Let's take 2008-09, for example. Most statistically cheap stocks were sold with the same ferocity as expensive stocks. The same scenario played out in the recent market sell-off in March, 2020.

In other words, cheapness protected no stock during these sell-offs. Valuation did not matter. Macro developments did become important.

It is also vital to recognize that AI, algorithmic trading and machine learning models are creating a whole new ball game when it comes to investing and volatility.

Value investors, at the very least, should learn from those who have underappreciated how grievous the impact of systemic macro flaws can be.

Take, for example, Bill Miller of Legg Mason

[BWG-N \(/investing/markets/stocks/BWG-N/\)](/investing/markets/stocks/BWG-N/) -0.23% ▼ . After beating the S&P 500 every year from 1991 to 2005, Legg Mason's Value Trust fund was down 58 per cent in 2008 because he dismissed the big picture and the severity of the liquidity crisis at the time. The collapse wiped out the fund's brilliant historical record.

No single strategy will work in all markets, and no single strategy will work forever.

It also seems that investors now go from one extreme to another. And this is also why we need something over and above bottom-up investing. Take 2017 and 2020, for example. The former was one of the historically least volatile markets since the mid-1960s; the latter, on the other hand, was one of the most volatile years, on par with 2008-09. Not only that, but much of the volatility in 2008-09 and 2020 was on down days.

Value investors address firm-specific risk by applying the margin of safety – only buying stocks when they are trading at a discount from their intrinsic value. However, if the stock market is overvalued, then even statistically cheap stocks will also fall.

For this reason, risks at the macro level must also be addressed within the value investing approach and, when appropriate, hedged. In more academic terms, what will hurt investors are not just things they do not know (captured by the traditional roulette or coin tossing-based measure of risk, namely volatility), but more importantly things they do not know they do not know (not captured by volatility).

Such risks can be minimized using put options on the market, something Nassim Nicholas Taleb, author of *The Black Swan*, advocates for because it can provide immensely asymmetrical returns in bear markets. Prem Watsa, the iconic chief executive of Fairfax Financial Holdings, also seems to be an advocate of such an approach and used it with much success during the great recession of 2008-09.

Especially these days, with the well-known geopolitical risks and elections soon to be held in the United States, I worry about the market. And I believe that investors, even though they should invest bottom up, should also worry top down.

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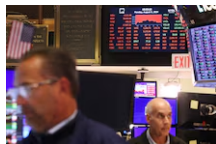
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