

Focus on the Manager

Jim O'Shaughnessy, Director of Systematic Equities

The way human beings are programmed is the perfect prescription for failing as an investor,

says Jim O'Shaughnessy, Director of Systematic Equities at Bear Stearns Asset Management (BSAM). Jim believes the key to gaining consistently above-average equity market returns is to replace emotion-driven decision making with the highly disciplined application of time-tested strategies. From his three best-selling books on investing—*Invest Like the Best* (1994), *What Works on Wall Street* (1996), and *How to Retire Rich* (1998)—to being named a “Market Guru”¹ alongside investing legends Peter Lynch and Warren Buffett, Jim has gained his success by convincing people to adopt this way of thinking about investing.

Born and raised in St. Paul, Minnesota, Jim has, since childhood, had an overwhelming desire to understand what makes things work—particularly the stock market and social and economic systems. While still in high school, he recalls listening to his two uncles argue about whether IBM was a buy or a sell. “As I listened, I realized they were pounding the table about their opinions without

considering the underlying conditions,” he says. “I thought, wouldn't it make more sense to, like Aristotle, try to classify things? Instead of trying to decide whether IBM was generally a good company, why not look at its underlying attributes such as price-to-sales and price-to-earnings multiples over time, and then aggregate the company to a group of other stocks with similar characteristics?”

To test his premise, Jim used the local research library to create a hand-written spreadsheet laying out 10 years of fundamental

characteristics for the 30 stocks in the Dow. He then pored over the numbers to see which factors seemed to have predictive qualities. This precursor of what would become Jim's life's work led him to conclude that, “If you can understand the underlying conditions, you can forecast the outcomes.”



Jim's interest in modeling systems led him to pursue a degree in rational expectations economics at the University of Minnesota. He explains, “Rational expectations economics was the first approach to question the status quo macro-economic models of the '60s and

'70s Keynesian era, which were built on the assumption that changing one variable in a master formula wouldn't affect

other variables.” Jim continues, “This was a radical idea at the time because it basically said all of the macroeconomic models the government and corporations were using to forecast inflation, economic growth, corporate earnings, etc., were essentially wrong. If you change the

“Marry a strong desire to know what makes things tick with a fascination with the stock market and you end up with the work Jim O'Shaughnessy began in high school.”

conditions of the game drastically, human beings will change their behavior."

Long before it gained acceptance, Jim's pursuits in economics fed his interest in what would eventually become known as behavioral

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finance—a field that seeks to explain investors' tendency to make poor decisions in environments of uncertainty. Behavioral finance challenges the assumption that individuals act rationally and consider all available information when making decisions. It instead looks to emotions and cognitive errors to explain why, for example, investors are typically willing to take more risk to avoid losses than to realize gains, or why people succumb to "fear of regret," which leads them to hold onto their losing investments while selling their winning investments.

The investment strategies Jim has developed are his answer to the problems posed by behavioral finance: remove the potential for flawed, emotion-driven decision making and let time-tested strategies run themselves. "We believe the use of a systematic, unemotional approach is key

to being continually successful in investing," he says. "It doesn't matter if you're focused on small or large stocks, value or growth; using a time-tested strategy in a consistent, disciplined fashion without ever letting your emotions get involved will ultimately lead to success," he states.

Under Jim's direction, BSAM's Systematic Equity team has three maxims it lives by. First, if an investment strategy can be tested, it must be tested over as long a period of time as possible. Why? "Because only the fullness of time and the greater number of observations will lead to any market-worthy conclusions," Jim explains. For each strategy, Jim asks, How volatile is it? What's the biggest loss it's ever incurred? How long did it take to recoup that loss? How often has it beaten its benchmark and by how much? What is the worst case scenario? His end goal is to find strategies that generate consistent performance with reasonable levels of risk.

Second, "We don't use a black-box approach to picking stocks; we use a Lucite box." That is, Jim will tell you exactly which factors he uses in a strategy and why.

He says his goal is not to encourage investors to blindly trust him, but rather to show them why his strategies work. "We want our clients to see we use price-to-sales because it's empirically proven over 52 years to be a good indicator of a company's potential for growth," he says. "We view our clients as investment partners." The better informed the investor is, Jim explains, the better they will do with his strategies over the long run.

Finally, Jim's team never leaves its strategy. "When we're performing well over benchmark, we don't get too excited. We're pleased, but not too pleased," Jim says. "When we're below benchmark,

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we remind ourselves that the reason we've been able to generate the track record we have is because we've never, ever left strategy."

Jim lives in Greenwich, CT, with his wife, Melissa, and their three children.

By Bobbie Turner, a financial writer based in New York City. 4/04