Interview in **Fonds professionell ONLINE**
4 March 2024

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Value manager: "Models that only work when you don't need them"

Tulips, turkeys and black swans: Hans Peter Schupp, CEO of the fund boutique Fidecum, takes a hard look at statistics in portfolio management and the investment models based on them in an interview with FONDS professionell ONLINE.

Hans Peter Schupp, Fidecum: "Of course, we are not immune to black swans. But at least we don't believe ourselves to be statistically safe."

Despite this quasi-natural deficiency, it is impossible to imagine portfolio management models without statistical indicators that originate from the past. Basically, everyone knows that the forecasts and trends derived from them have undeniable weaknesses. No wonder that this creates a kind of false security, which is often mistaken for reliability. Hans Peter Schupp, CEO of Fidecum based in Bad Homburg and portfolio manager of the Contrarian Value Euroland Fund, warns in an interview that it is not without reason that fund managers should not think they are too safe with their models.

Mr. Schupp, you calculate and publish many quantitative key figures for your funds. In portfolio management, however, you use these just as little as the portfolio optimization tools. Why such reservations?

Hans Peter Schupp: *When you cross a road, you look left and right to make sure there is no car coming. Or would you calculate the probability of a car coming from the historical traffic frequency? Modern portfolio theory does the latter, as it only takes into account historical price trends, returns achieved and their fluctuations. This is based on the efficient market hypothesis, which in its general form states that security prices contain all available information at all times and that further analyses are therefore obsolete. Securities are then sought whose prices have not developed in the same direction in the past, with the aim of constructing a portfolio from them. This portfolio is less susceptible to fluctuations because other securities compensate for a possible misallocation.*

So the advantage of appropriate diversification is basically undeniable, isn't it?

Hans Peter Schupp: *You could, of course, say in a very simplified way that a street vendor who has just sold sunglasses usually also has umbrellas in his repertoire to offer those as soon as the first drops fall. However, the question is whether historical price trends, returns and their fluctuations, as used in quantitative portfolio theory, are the right selection criteria for hedging against eventualities. Ever since 1637, the year of the so-called "Tulip Mania", we have known that the most dangerous investments are speculative bubbles. Because the price is based solely on the hope of new investor capital.*

This of course stems primarily from their price performance before the bubble burst, basically the phase in which they appear to be optimal investments for portfolio optimization.

Hans Peter Schupp: *Absolutely right, I would even add that the following complicates matters: speculative bubbles combine high returns with a generally low fluctuation margin and only a low correlation to other securities. This is the real reason why investors are often subject to the so-called "turkey illusion". This is a term from behavioral economics that explains the emergence of surprising trend breaks by the fact that the causes and underlying conditions for a trend are not challenged. In my view, this is in some ways just as much a mystery as the still very popular risk indicator "value at risk"...*

... but whose statement - apart from the residual risks that always remain - sounds quite plausible at first?

Hans Peter Schupp: *I actually agree with you if you assume that a figure such as "value at risk" quantifies the maximum risk of loss of an investment or a portfolio with a probability of 99.5 percent, for example. At first glance, this seems to be a very practical tool in portfolio construction, if it only worked.*

What is the crux?

Hans Peter Schupp: *With "value at risk", it is precisely the neglected residual probability of 0.5 percent in this case. In other words, the indicator becomes a model that only works when it is not needed. Would you like an example? A normal trading year has around 200 trading days. And on 199 days the model works perfectly, but the one day on which the stock market really crashes is outside the 99.5 percent probability. This apparent certainty of "value at risk" becomes even more blatant when a so-called black swan event occurs, an event that is not taken into account because it is unthinkable. September 11, 2001 was such a black swan for insurance companies, because until then it was inconceivable that one event could lead to an accumulation of various claims from liability, building or life insurance policies and at the same time to a global stock market crash. Until then, terror was considered a danger in definable regions and in many countries it was even covered by general insurance policies as a practically free service.*

What conclusions do you draw from this for the management of your own fund?

Hans Peter Schupp: *As you mentioned in your initial question, we also use the relevant key figures and models. But without relying on them. We prefer to do as we do when crossing a road, by looking left and right. That's why we prefer to look at the companies we invest in from a fundamental perspective rather than calculating any probabilities. Admittedly, you can also miss a car coming when crossing the road. In investments, these events are called "value traps", i.e. traps that fund managers can also fall into. And of course we are not immune to black swans. But at least we don't believe ourselves to be statistically safe.*

Thank you very much for the interview. (hh)

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