Rise of the machines?: Thinkers will stay on top

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New terms and tools, but same concepts and tough decisions
Developing a disciplined investment process and decision framework doesn’t cut it anymore. This is the age of artificial intelligence. If process is crucial, then it should be expressed as an algorithm, preferably in software code, executed by computers or perhaps robots with happy facial features if human interaction is required. If your investments aren’t managed by HAL, then you must be an ape. Right? Wrong!

The stock market is a sophisticated decision making machine
The stock market is a mechanism that aggregates decisions, by people, computers and usually both working in tandem to determine: What’s this stock worth right now? This decision is made in a dollar weighted democracy; in which votes are cast with risk attached, dollar weighted to the voter’s confidence and risk-reward tolerance, whether this is cognitive or programmed. The price that emerges reflects what is known, most probable and the alternatives that instant, imperfectly but objectively.

The determinants of value have been mostly the same for centuries
The stock market is not a cosmic mystery. Value is determined by future profits. Forecasting future earnings is difficult and uncertain. There are no rules to how the future of a company or an industry or an economy will unfold. There are no rules to how the market’s collective genius should go about forecasting the future. There is only what people and their computers can and can’t do. We use current facts and history as a guide, but stay mindful of the many things that can change.

How to beat a market that reflects the best of man and machine
Opportunistic or active investors must grapple with questions like what is this stock worth normally or in a future different than what is suggested by the share price. There is no magic formula or patterns to find. Fund managers must develop well reasoned operating outlooks with profit forecasts and consider current valuations. The general approach we advocate is to: 1) estimate normal earnings, 2) estimate growth in economic profits, if the business has convincing prospects of such, 3) use DCF and other valuation models, like CROCI, to determine present value, 4) do this analysis as rigorously and consistently as possible across the target universe, 5) construct a portfolio of stocks that maximizes expected return per targeted risk.

Systematic active strategies well suited to broad large cap funds
The deep dive process above requires significant resources to do well and often it’s difficult to find compelling reasons to differ with the market’s outlook for profits at mature large cap companies as implied by share price. Thus, for broad equity portfolios, like well diversified large cap Core or large cap Value funds, a systematic process, fundamental in nature, can succeed when risk is carefully controlled and outperformance goals kept modest but material overtime. It’s usually with more dynamic Growth stocks and small caps that deep analysis delivers outperformance.

Stay long the thinkers: Seek conceptually robust frameworks
Whether it’s enhanced passive or systematic active or specialized fundamental portfolio managers with the knowledge and experience to assess the future of a business or industry, we advise investors to seek conceptually robust frameworks that center on the fundamentals of intrinsic value and seek attractive risk adj.

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Diversification neither guarantees a profit nor protects against a loss.

Definitions:

Discounted Cash Flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. It uses analysis consisting of future free cash flow projections and discounts to arrive at a present value estimate to evaluate the potential for investment.

CROCI® is a proprietary valuation methodology, which dates back to 1996 when it was developed by Deutsche Bank and attempts to understand the real value of a company.