

Global Macro and Value Investing from the Trader-vs-Investor Perspective

Some are traders, some are investors, everyone is a speculator by nature

Speculation is defined as “the forming of a theory or conjecture without firm evidence”. In other words, speculation is what triggers hypotheses, hence the first step on the path of knowledge and decision making. When we lack information, we have no alternative but to speculate to some degree. It is no surprise then that we do it repeatedly in our everyday lives. For instance, when it comes to attending an event, we speculate on the time needed to arrive punctually.

When it comes to investing, the need to speculate is no different. Since it is a game of limited information par excellence, approaching it with a hint of speculation becomes inevitable¹. This does not mean, however, that all market participants invest with the same degree of speculation. In fact, the investment world can be thought of as a spectrum of speculators. On one side, traders buy things in anticipation that somebody else will buy them at a higher price in the future. They tend to jump in and out of the market frequently. On the other extreme, investors try to figure out how much something is worth and buy it for less. They are characterized by having long-term horizons. In between, where most individuals fall, elements of both practices are blended.² Traders speculate to a much greater extent than investors as they are willing to buy securities backed by shallower theses.

Traders and investors approach markets differently largely because they deal with different levels of knowability regarding fundamentals.³ Specifically, traders have a less in-depth understanding, if any, of the underlying causes than investors. This is due to either a deliberate decision to analyze other factors instead or due to focusing on fields that are inherently less knowable. Put another way, traders give fundamentals less weight in their analysis, and so rely on other inputs that they consider to be of equal or greater importance, such as price movements. Investors, by contrast, center almost entirely on fundamentals.

Such approaches entail different risk management processes. This is because knowability determines whether risk is perceived through price action or fundamentals. When knowability is hard to come by we must place further emphasis on the idea that the collective (i.e. the market) generally knows something that we do not. So, if price swings shape one's conviction, it naturally follows that large drawdowns are to be avoided. The opposite occurs when knowability is somewhat easier to come by. In this case, one can better understand what is being owned, and thus still maintain enough conviction when Mr Market is feeling

¹ Speculation often carries a negative connotation as it is incorrectly associated with gambling. The former involves taking a calculated risk, meaning that the decision need not be risky from a risk-reward standpoint, as the latter is.

² Throughout this piece, though, we will use the terms “investing” or “investor” to refer to the overall activity of allocating resources with the purpose of generating a return. The expressions “trading” or “trader” will be used only when intending to differentiate the two practices.

³ According to Merriam-Webster, knowability is defined as the “capability of being known”, and fundamentals as “of or relating to essential structure, function, or facts.”

depressed. As a result, traders define risk as volatility, a price related measure, whereas investors as the probability of permanent impairment of capital, a pure fundamental concept. Successful traders typically do not experience big drawdowns, while successful investors frequently do.

Global macro vs value investing: their relative place on the trader-investor spectrum

Global macro investing studies large macroeconomic forces that sit at the intersection of extensive fields such as economics, politics, geopolitics and history. In particular, economics is inherently political because, as Keynes expound, economic dynamics arise from human political arrangements. Economics is essentially about the relationships between markets, people and governments. From this top-down analysis, macro investors attempt to profit from four main asset classes (equities, fixed income, commodities and currencies) rather than from individual stocks.

Value investing is a totally different game. It focuses on estimating the value of any given security and buying it for less than it is worth. Expressed differently, it's about buying securities whose prices are lower than what their fundamentals suggest they should be. This approach is typically applied to the equity side of businesses, and so it is based on the premise that investors who buy a stock in a company own part of the business, not a tradeable piece of paper. Therefore, value investors are in essence business owners. They try to think and act as if they were the company's CEO.

As business owners, they analyze first and foremost the company's capacity to allocate capital efficiently for the foreseeable future. This is paramount since, as William Thorndike shows in *The Outsiders*, "two companies with identical operating results and different approaches to allocating capital will derive two very different long-term outcomes for shareholders." In an effort to determine the sustainability of those returns, value investors focus primarily on the company's fundamentals, such as its competitive advantages, management team, incentives structures, and competition. Simply put, they undertake an exhaustive bottom-up analysis.

Although both styles are extremely hard to master⁴, global macro investing poses a higher level of complexity. The limits that constitute the macro field are more extensive and diffuse than those of the micro. By covering a larger area, it encompasses a greater number of variables, making it more common for spurious relationships to emerge. Therefore, trying to visualize macro developments can often be like trying to hold water in your hand. It simply slips through your fingers.

In contrast, the value investing puzzle has relatively fewer pieces as businesses evolve within narrower boundaries. This makes its pieces more tangible and measurable, and so less

⁴ Investing is in itself a highly complex endeavor much like solving a jigsaw puzzle with constantly moving and shifting pieces.

complex to envisage their future progression. For instance, consider the difference between analyzing the prospect for gold and Starbucks, or the company you are running or working at. You will soon realize that gold is far more complex to grasp.

Understanding complexity is crucial because it directly affects the level of knowability, which, in turn, determines where each style falls on the trader-investor spectrum. The capability to know something decreases as complexity increases, and vice versa. As outlined in the first section, when knowability is elusive, a trader's approach becomes inevitable, whereas when it is in greater availability, acting as an investor makes more sense. Consequently, the macro investor falls closer to the trader than the value investor.

Technical analysis and margin of safety as risk management processes

The fact that they are at different points on the trader-investor spectrum means that they view risk differently and therefore use different methods to mitigate it. Essentially, such methods are a built-in cushion that allow for inevitable mistakes or unexpected events to occur while substantially reducing the probability of being wiped out. As we'll see, these risk management tools are far more an art than a science.

Global macro investors outright avoid sizable drawdowns. Given that macroeconomics is a less knowable field, it becomes harder to build enough conviction to withstand deep declines. As a result, most macro investors do not feel comfortable adopting very long-term, buy-and-hold strategies. They might carry out rigorous fundamental analyses regarding the direction of the business cycle, but price is the ultimate barometer. In other words, they are always on the alert that the market may know more, and so generally establish a price level (i.e. stop loss) where they assume they are wrong.

In order to incorporate this notion that price is the final arbiter of truth, they use technical analysis as their main risk management tool. Put simply, technical analysis refers to the use of patterns in data, mostly price, to determine potential trends. Macro investors recognize their limitations to fully comprehend their field and assume price charts may reveal something they are missing out. Expressed differently, charts are used to simplify the complexity embedded in markets. They give some order to the chaos by aggregating all market participants' beliefs and emotions.

It so happens that in complex systems less is often more. Although technical analysis may seem a very rudimentary tool, used wisely in diffuse environments can be hugely beneficial. In *Antifragile*, Nicholas Nassim Taleb explains that "simpler methods for forecasting and inference can work much, much better than complicated ones. Their simple rules of thumb are not perfect, but are designed to not be perfect; adopting some intellectual humility and abandoning the aim at sophistication can yield powerful effects."

In that regard, technical analysis is not used to predict the future, but simply as a map of where markets have been and may likely be heading, as well as a means to constantly test

fundamental hypotheses and update their probabilities. For Bruce Kovner, “technical analysis is like a thermometer” that he always checks “to know where the market is - whether it is hot and excitable, or cold and stagnant.” Peter Brandt adds: “I will be first to admit that charts do not forecast price - they show the path of least resistance and provide excellent risk management tools.”

Furthermore, the adage “a picture is worth a thousand words” perfectly captures the essence behind technical analysis. Charts often tell a story. They offer such a visual input that many macro investors prefer to start their analysis by scanning them. If something interesting pops up, they then go on to research for fundamental reasons that may be behind that story. Only if the two processes are aligned, the investment thesis is then executed. As Raoul Pal perfectly summarizes, macro guys are “big picture thinkers who see things visually.”

For all of the above, technical analysis serves as a signaling mechanism. Macro investors can identify relevant areas where an investment thesis is likely to succeed or fail, allowing them to quantify some of the risk and spot positively skewed risk to reward ratios. Last but not least, chart patterns help save mental energy by reducing market noise.

Value investors, in contrast, fully embrace large drawdowns. Such events present an opportunity to double down if the thesis remains unchanged. Again, this behavior is possible because microeconomics is relatively more knowable, making it easier for investors to hold on to the security when Mr Market is being pessimistic. As Joel Greenblatt explains, “When something falls twenty or thirty percent, I don’t panic because I know what I own.”⁵

To guard against potential misjudgements of fundamentals, value investors apply the concept of margin of safety. As previously described, value practitioners focus on buying something for less than they think it’s worth, so they turn greedy only when the difference between their estimated intrinsic value and price is wide enough. The wider the margin of safety, the bigger the protection in case things don’t work out as expected. This reduces the need to know everything without sacrificing asymmetric opportunities. As Guy Spier puts it: “If I pay too much upfront, I’d better understand everything there is to know about the company since there is no margin of safety. If I invest when it’s undervalued, I can be wrong about a whole host of issues and still make a good return.”

Estimating a company’s intrinsic value is anything but an accurate exercise. Warren Buffett defines it as the “discounted value of the cash that can be taken out of a business during its remaining life.” As can be noticed, it is subjected to assumptions that vary from one person to another. Consequently, intrinsic value is a range of possible values rather than a precise number. Successful value investors use a set of realistic but conservative assumptions and buy when they have a good margin of safety on them.

⁵ Although value investors may understand what they own, going through such drawdowns is far from being a walk in the park. Emotions can become hard to control and may end up eroding conviction. What you thought you knew, now you don’t. Being able to dominate emotions is one of the key skills that sets apart great investors from average ones.

In order for assumptions to be sensible they must be grounded in both qualitative and quantitative fundamentals. One of the most important assumptions that needs to be made is whether the company will continue to be in business for the foreseeable future. As a result, the analysis is largely focused on trying to kill the company. As Bruce Berkowitz says, “We try every way to kill our best ideas. If we can’t kill it, maybe we’re on to something.” This involves evaluating the company’s competitive advantages, which mainly depend on the quality of its internal processes, managerial skills and incentives, and industry dynamics. The sustainability of such considerations, in turn, affect expected future cash flows and the ability to reinvest them efficiently.

Nobody knows exactly how long it will take for price to converge to intrinsic value, but that’s something that does not concern value investors. As long as they have a wide margin of safety and their thesis remains intact, they are willing to wait and endure Mr Market’s depressive moods. In the long run, Mr Market is a “weighing machine” and will recognize businesses’ true fundamental values.

In a nutshell, the methods both types of investors employ to manage risk are nothing more than a reflection of each style’s spirit. Technical analysis and margin of safety attest to the level of knowability to which they are constrained, their place in the trader-investor spectrum, and their risk and volatility perception, among other features.

It ultimately comes down to personality

We humans are a product of nature and nurture. In other words, our personality has been shaped by both our genetic inheritance and the experiences we have gone through. Due to this mechanism, we have developed unique lenses with which we see, understand and approach the world.

Knowing how these forces influence our own behavior is key in any endeavor, but more so in investing. This is because successful investing is, for two main reasons, a highly individual activity. Firstly, committee-like decisions are likely to lead to groupthink bias, killing creativity and accountability. According to Charles Ellis, “If investing is all about creativity and making unusual, unconventional, and even unpopular decisions, great investment decisions are best made by individuals taking direct responsibility for the results of their own acts.” Secondly, money exacerbates all sorts of emotions: greed, fear, envy, shame, frustration, etc. These are deeply personal, with some of them being triggered within us more intensely than others. As neuroscientist Joe Dispenza defines, “emotions are the vocabulary of the body and the chemical residue of past experiences.”

Dominating the emotional side of investing is critical, and one way to become better at it is to make sure one's character is in harmony with the selected style. As we have seen so far, global macro and value investing are two very different styles that call for different character

traits. So, whether one should invest under one or the other ultimately comes down to personality.⁶

When multiple forces interrelate between each other and give way to a very complex system such as macroeconomics, the all rounder approach becomes indispensable. Concentrating too much on the details doesn't pay off in macro investing. It is only when seeing the forest for the trees that these types of investors can have a good shot at imagining what the future macro jigsaw puzzle will look like.

Top global macro investors display such qualities. Philosophically speaking, they tend to be more skeptical that things can be known in their entirety. They believe that any effort made with such a purpose is likely to be worthless. In addition, they are wired with a more generalist and top-down mindset, enjoying focusing on big trends rather than particular ideas that demand a deeper analysis and granularity. This is not to say that macro investors are lazy, but simply that they are not wired with the intensity required to continuously solve multiple jigsaw puzzles.

In contrast, value investing allows for a more detail-oriented mindset. That is, value practitioners can swim through the details in greater depth before it becomes counterproductive. As opposed to solving one big jigsaw puzzle, they must solve multiple ones simultaneously, as each company is a unique world. Due to thousands of companies to invest in, specializing to some extent in certain geographies, industries or business models is required in order to have an edge over the market.

Great value investors clearly exhibit traits consistent with such an environment. They are several degrees less skeptical. From the perspective of the macro investor, they even appear somewhat idealist. Not only do they believe that things are more knowable, but many of them seek to partner with businesses that have a good chance of transcending and changing the world for the better. Therefore, it is no coincidence that value investors are characterized by a business owner mentality that naturally pushes them to make sense of the world from the bottom up and enthusiastically study unrelated topics simultaneously.

In short, being both a great global macro and value investor is impossible. The personality set required for one style comes short of the specific traits demanded by the other. The two sets cannot coexist in one person, and logically so. Nature endows investors with one or the other. At the end of the day, much of successful investing comes down to figuring out a style that truly resonates with who we are.

Such is the importance of finding harmony between one's personality and investment style that it makes investing the only discipline in which an amateur can beat a professional over a

⁶ It is important to mention that all great investors share a set of common traits, regardless of their investment style. Consequently, personality differences should always be viewed with relative, not absolute eyes. Put another way,, the fact that one type of investor is characterized by certain qualities does not mean that others do not possess them at all, but simply that they are relatively more prone to the extremes than others.

long period of time. Even though they are less knowledgeable about financial markets and may have a lower intelligence quotient, amateur investors can very well outperform pro money managers with a simple but robust framework that better matches and controls their temperament. The investment industry is full of sexy-sounding managers who add no value because they fail at mastering the emotional game of investing. As Buffett said, “investing requires the qualities of temperament way more than it requires the qualities of intellect.” At its core, successful investing is fairly mundane.