The Disciplined Investor Podcast – Guest Interview Summary

Guest: Wes Gray
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Quant-Based Investing Transition Discussion

Wes shared his transition from discretionary stock picking to a quant-based approach, explaining how his research on the Value Investors Club revealed that computer-driven strategies could replicate the performance of human stock pickers, particularly in small cap value investing. He noted that while small cap value strategies performed well from 2000 to 2008, the approach has underperformed since then, with buying the S&P 500 becoming more profitable in recent years.

Investment Strategy and Portfolio Construction

Wes and Andrew discussed investment strategies and market dynamics, particularly focusing on the historical performance of value and growth investments in the 1990s. Wes explained that their ETF construction approach uses around 50 stocks due to academic research methods, rather than industry-standard practices that focus on minimizing tracking error. The discussion touched on liquidity management challenges with concentrated portfolios, though this topic was not fully resolved in the conversation.

ETF Infrastructure Business Approach

Wes explained how his firm took a different approach to asset management by starting an ETF infrastructure business that does white-labeling work rather than directly managing large-scale funds. He discussed how most asset managers face pressure to scale due to fixed costs, leading them to pivot toward closet indexing, while his firm's infrastructure model allows them to maintain their research-focused approach without the same economic incentives to grow at all costs. When asked about pitfalls in backtesting quant strategies, Wes acknowledged the common issues of data snooping and survivorship bias, and indicated he would discuss how to address these challenges in the continuation of their conversation.

Investment Strategy Performance Evaluation

Wes discussed the importance of evaluating investment strategies through rolling 3-year performance comparisons against benchmarks, explaining that this timeframe aligns with typical institutional mandates. He emphasized that successful strategies should show consistent outperformance relative to benchmarks over different time periods, noting that value and momentum strategies tend to perform well in this analysis. Wes also highlighted that while certain strategies like trend-following may work over the long term, they often underperform compared to simple long-only approaches in recent market conditions, making them unsuitable for managing other people's money.

Investment Psychology and Strategy Discussion

Wes and Andrew discussed market psychology and investment strategies, focusing on how human emotions like fear and greed affect investors despite educational efforts. Wes emphasized the importance of systematic approaches and suggested using a "fun bucket" strategy where a separate portion of funds can be used for speculative investments while maintaining systematic processes for the main portfolio. Andrew shared his experience with commodities in client portfolios, expressing frustration with their performance and explaining his theory about price ceilings in energy commodities.

Commodities Trading and Managed Futures

Andrew discussed his experience with commodities trading and his decision to shift to a managed commodity ETF style that invests in 14 different commodities primarily in backwardation. Wes explained the principles of managed futures programs, highlighting the importance of contango versus backwardation and trend following strategies as key drivers for performance. They also discussed current market conditions, including high Treasury and Japanese bond yields, and how managed futures strategies have been performing in response to these conditions.

Market Environment and Strategy Discussion

Wes and Andrew discussed the current market environment, with Wes explaining that they are in a period of high "animal spirits" characterized by low risk aversion and extreme FOMO behavior. Wes noted that while the market appears overvalued and driven by news and stories rather than fundamental economic indicators, it's difficult to profit from such conditions as predicting market tops is nearly impossible. They agreed that the strategic approach in this environment should focus on boring fundamentals like diversification, fee reduction, and owning basic assets like commodities and bonds.

Concentrated Stock Management Solutions

Wes and Andrew discussed solutions for managing concentrated stock positions, particularly focusing on the 351 exchange fund structure. Wes explained three main approaches: exchange funds which require a 7-year holding period, long-short tax-loss harvesting which takes 2-4 years, and 351 exchanges which allow tax-free contributions to ETFs but require diversification with no single stock exceeding 25% of the contribution. Wes noted that while the 351 solution offers the most flexibility with no holding requirements, it comes with strict diversification requirements that make it unsuitable for pure concentrated positions.

Investment Diversification and Tax Strategies

Wes and Andrew discussed investment strategies, focusing on diversification and tax implications. Wes explained the benefits of moving concentrated investments into diversified portfolios, including reduced volatility and better access to capital through lending markets. They also discussed the evolution of structured products, with Wes noting how ETFs have made buffer and outcome-based products more transparent and tax-efficient, competing with traditional insurance-based strategies.