Investment Beliefs: Separating the Real Stuff from the Fluff

By Michael Falk, CFA and Jim Ware, CFA

The Problem:

Hiring and firing decisions by plan sponsors are habitually poor.[i] They classically hire the "hot dot" manager and fire the Not (so)-Hot-Dot one (i.e. the underperforming manager). Because good managers don't stay "down" and hot managers cool off, plan sponsors often make precisely the wrong decision – sell low and buy high. In this process, we understand the agency problem: how can a plan sponsor tell their board, "We are hiring a manager with a weak record!?" Of course, they cannot. But wait, it gets even better, what if the plan sponsor adds: "And we are firing that one high performer!" Good luck with that pitch!

Plan sponsors face the ongoing challenge of selecting superior managers. In our research, plan sponsors overwhelmingly identify Investment Philosophy and Process as the key determinant in making their decision.[ii] Presumably a manager's performance record defends the value of their Investment Philosophy and Process. Logically then, the selection process needs to start with performance numbers over a complete cycle. After all, without defensible numbers there's always the choice to go passive.

Beyond the numbers, what explains the good track record? Why would the superior results persist? Too many firms have what we would call "fluff statements."[iii] A fluff statement sounds perfectly logical but doesn't help us understand why a firm could outperform. The most blatant example would be, "We buy low and sell high by employing hard working, smart professionals." (Remarkably, many investment firms identify their strategic edge as "smart staff" and "hard work.") At face value, this statement makes perfect sense. But it tells us nothing about the competitive edge. All firms try to buy cheap and sell dear, and all firms—that we've encountered—have smart, hard working professionals.

To take a real example of fluff from a firm's statement, consider this one:

"We seek to build models of both the fundamentals and of a macro overlay and use both to forecast security returns."

Lovely, but what have you told us about competitive advantage? And forecasts, really, are we not beyond that failed endeavor? Perhaps James Grant has put it best with "how rarely the light of prediction illuminates the darkness of the future."[iv] What firm hasn't tried to do some or all of this? If you are in the investment space, is this not what you do? What we want to know is what are your investment beliefs and practices that allow you to add value. A good investment beliefs statement includes a valid competitive edge. It answers the question, "How can we hope to win in a fiercely competitive environment?" A savvy investment manager recognizes that all humans suffer from overconfidence bias—I'm in the top half!—so they need to think carefully about the reality of what it takes to actually outperform.

A Solution:

The following statements are candidates for meaningful competitive advantage rather than fluff. Please note that competitive advantage does NOT guarantee alpha, but it does provide the greatest likelihood of success. They should be among the minimum requirements when selecting an active manager.

1) Significant cognitive diversity on the team. More than age, gender and ethnicity (AGE), cognitive diversity means genuinely different thinking styles.[v] Scott Page writes "We find that cognitively diverse groups can locate solutions to difficult problems and that diverse groups tend to outperform groups of the individually best agents."[vi] In short, five middle-aged white guys with Ivy League educations will not perform as well as sufficiently intelligent people with diverse thinking styles. People approach problem solving in different ways: some people start with data, some start with a process, some dive in and rely heavily on "blink" (intuition). Welcome the wisdom of the crowd into your office; it can provide a significant edge.

   Pushback: (Questions you would want to ask, to make certain the manager has cognitive diversity)
   a. How are you measuring cognitive diversity? Acceptable answers might include: Myers-Briggs Type Indicator or the Kolbe Type Indicator.
   b. Are you using the cognitive diversity? That is, does your team of diverse people engage in rigorous debate? Do ideas get introduced and fully vetted by all team members?
   c. Do you guard against endowment bias? Does the person who introduces the idea "walk away" from the debate for a time while the others vet the idea?

2) Processes that use durable and/or proprietary factors. Again, the track record would have to provide evidence that the factors indeed work.

   Pushback Questions:
   a. Has the strategy has been consistently applied over the measurement period, such that you could have reliably predicted the returns given the market's information?

b. Has there been a low percentage turnover of the dollars invested in the strategy? That is, do the clients understand the strategy and stick with it during the hard times?
c. Has AUM outgrown the strategy? That is, the fund is now too large to capture the processes alpha.

3) Learning agility, meaning the professionals learn from their experience. As in the famous Keynes (?) quote, “When the facts change, I change my mind. What do you do, sir?”[vii] Hindsight bias suggests accurate journaling is the only way to reliably learn from the past. We re-write history in our minds, so to learn we must be able to compare results with our original decision logic. Not our imaginary version of it! Moreover, this re-writing appears to be a function of our brain’s wiring to help maintain our mood[viii]. If a manager asserts that they are continuous learners, we suggest you pushback in the following ways:

   Pushback Questions:
   a. Do team members keep journals of their decisions? 90% of investment professionals do not![ix] Ask to see a sample journal.
   b. Does the team “come clean” in their post-mortems? Are they willing to document mistakes, such that they can then learn from them?
   c. Ask for an example of an important lesson from past experience. Describe how it improved ongoing performance?

These are just three of many possible “fluff-less” statements. But each of them merits further exploration because they have only the “kernel” of legitimacy. They require follow up questions to fully understand their robustness, but they pass the first test: they are not fluff.

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[i] Goyal and Wahal, Journal of Finance, 2008 and Stewart, et al Financial Analysts Journal, 2009

[ii] Jim Ware, speech to Global ARC, Fall 2010. Data collected real-time from audience of 100 institutional clients and plan sponsors.

[iii] The phrase "fluff" is taken from Richard Rumelt's fine book called, "Good Strategy, Bad Strategy" (Crown Business, New York, 2011). He writes, "Fluff is a form of gibberish masquerading as strategic concepts or arguments." Pg. 32

[iv] James Grant newsletter

[v] See Scott Page's excellent book, "The Difference: How the Power of Diversity create better groups, firms, schools, and societies" (Princeton University Press, Princeton, 2007)

[vi] Opening quote from Michael Mauboussin's "Investing with Style" (the consilient observer, November, 2002)

[vii] John Maynard Keynes. While no direct evidence exists that Keynes stated this, he continues to receive much of the attribution. http://quoteinvestigator.com/2011/07/22/keynes-change-mind/

[viii] Paul Kleindorfer, "Reflections on Decision Making Under Uncertainty" (INSEAD WP, 2008). He writes, "… arises undoubtedly from our biological heritage in seeking meaning and order in life so that we can continue to function without undue neurosis." Pg. 15 and Lionel Tiger, "Optimism: The Biology of Hope" (Simon & Schuster1979)

[ix] From FCG real-time survey results of CFA audiences globally, when asked, "Do you keep a decision journal?"