

## Successful Investment Management: Through a Philosophical Prism

The management of abstract wealth, i.e. equity shares, debt and their derivative products has always been part science and part art. The *science* of investing has undergone a revolution since 1974. First, desktop computers were introduced to calculate yields rapidly and collect and sort the geometrically growing number of facts. A new generation of market makers and investment managers who could master these machines rapidly took center stage in the investment business. The overwhelming competitive advantage these managers had should not be underestimated: They pushed most bank trust departments into obscurity, and built the modern investment management business. They were praised copiously in print and their styles became very well known.

Soon thereafter, computer facilitated research produced new theories of investment management such as Modern Portfolio Theory and the concepts of Alpha, Beta and Gamma etc. Around the millennium change, many of those great and fabled managers retired, leaving many clients and trustees still intensely loyal to the firms that produced great historic returns, but not very knowledgeable about the younger portfolio managers.

There has been no equivalent revolution in the *art* of investing. The art form of investing was much more important in the pre-computer era. Now that computers are ubiquitous among investors at all levels, the art form used to obtain results will be of increasing importance. Art in this context is difficult to define, but at the very least it should encompass the data interpretation skills of the manager. This paper seeks to identify some of the non-scientific qualities of successful investment managers as seen through the eyes of a veteran of 25 years as a portfolio manager and almost as long as a foundation trustee.

Capital management is an ancient business. Sumerian tablets survive that describe in small detail; rents, goods prices and interest rates. The oldest known story of investment performance measurement and asset allocation is found in the Book of Matthew 25, 14-30, known as the Parable of the Talents. The story tells of a rich man who is leaving for an unknown period of time. He called in his servants (capital asset managers) and instructed each to manage part of his cash wealth. His original asset allocation: “to one he gave five talents, to another two, and the another one, to each according to his ability, then he went away.” (Matthew 25:15).

The rich man returns after a long time and demands a reckoning. The first servant describes doubling the five talents into ten, the second servant doubling the two talents into four, and both are praised for their management. In the famous dialogue between the “wicked and slothful “ manager that merely buried the money in the ground, the rich man does not even put the man on the “watch list”. He is fired on the spot. Subsequent to this first ever recorded “investment performance review”, the rich man re-balances his

portfolio. “So take the talent from him (the manager who didn’t even bother to collect bank interest), and give it to him who has the ten talents (Matthew 25:28). An interesting move.

**While** it is unlikely that the rich man knew of Modern Portfolio Theory, and perhaps did not have an “efficient frontier” to achieve based upon the past results of his managers, he made a clear decision that is counter-intuitive to today’s trustees, i.e. he continued over-weighting his largest portfolio manager despite ostensibly identical results. Is it possible that he could have known about risk adjusted returns? Or did he have a firm grasp on the underlying philosophy that the managers employed in their commerce, and that motivated his decision?

**The** current process of asset allocation and of selecting an investment manager would seem, on the face of it, entirely scientific. The manager’s policies, procedures and practices are examined in varying detail. Computers track monthly returns which are organized into alphas, betas, gammas, upside/downside capture ratios, Sharp ratios, efficiency ratios and so on. All of this is supposed to produce a single scorecard of “performance” that is in turn audited by an outside accounting firm for purity. These sanitized scorecards are presented to trustees via the consulting community, conveniently organized by style, objective and total returns.

**The** Employee Retirement Security Act of 1974 (ERISA) so completely transformed the role of trustees that an entire new industry, investment consulting, was born to generate performance data on investment managers. Notwithstanding their political or social preferences, most trustees are quite conservative and they are generally loathe to change managers. Changing managers means the termination of a relationship and searching for a new one. If the “relationship manager” has does their job well, this is very painful (this is why so many institutions stay with 4<sup>th</sup> Quartile managers year after painful year). At some point, however the consultant or the committee chair demands action. A search begins.

**The** consultant or broker (or committee member) searches private data bases screening for attributes that have been pre-selected by the data gathering firms whose styles currently “fit” into a mathematically almost incomprehensible asset allocation model. Trustees typically pick the top three or five from the category in question (large cap growth, small cap value, etc.) for a “beauty contest”, and after presentations lasting 20 minutes to one hour or more (to digest this data carefully), millions of dollars move from one manager to another.

**Finals** presentations are often pure theatre and some of the stars make Hollywood salaries. Like rock shows on tour, these presentations are vetted word by word to present an image, a look, a feel, a sense of connection with an abstraction. So important are these presentations that there is a subsidiary industry in money management (just as in musical entertainment) that crafts and designs these, often with a particular set of trustees in mind.

There are organizations dedicated to trustee education and training, and course materials are becoming ever more sophisticated. And while trustees are almost always thoughtful and faithful to their roles and responsibilities very few are able to grasp the true issues underlying the scrubbed, sanitized and theatrically presented historical performance results. They are not trained to ask the correct questions. Sometimes the missing information is significant.

**We** have all seen this boilerplate: **“Past performance is no indication of future results”**. What nonsense! The exact opposite is true. Did the rich man in Matthew’s story suppose that the slothful servant would change his policies and procedures? He did not give him a chance to.

**Past** performance can indeed be a very good indication of future performance if the viewer is not looking solely at a series of numbers trying to divine the next value in a predetermined sequence. If performance is defined as the cumulative reaction (of a human being) to a long-running set of stimuli and market circumstances, it can be reasonable predicted. Careful consideration must be given to the philosophy (art form) that generated historical results before any faith can be given to the assurance of their repetition. If behavior is seen as the creator of performance, the past is indeed prologue.

**Successful** managers normally exhibit behaviors that include several of the following elements:

**Trustworthiness** is the single most important element. In this context, trust is not just the absence of large or petty falsehoods. Rather it is the faithful adherence to stated personal principles. Has this manager adhered strictly to the stated processes and procedures? When the style was out of favor did the manager drift even slightly to satisfy the demands of the salesperson screaming about performance? Has the personal benchmark by which the portfolio manager gauges their performance been stretched or widened over different market cycles?

**Trustworthy** managers speak openly and humbly of their successes and failures and will generally discuss them. Managers who possess a strong personal character can be trusted to stay on their course and not wander. Heraclitus declared that “character is destiny”. He could have been speaking about the management of your money.

**Pragmatic** is second. Derived from the Greek word *pragmatikos*, its modern definition is “concerned with causes and effects or needs and results rather than ideas and theories” (Webster). Pragmatism is more than a system for viewing and processing data, it is the philosophic framework for taking repeated actions.

The concept was first introduced into philosophy by Charles S. Peirce in the January 1878 Popular Science article titled ‘*How to Make Our Ideas Clear*’. His seminal idea was that our beliefs are really rules for action, and to develop a thoughts meaning, we need only determine what conduct it is fitted to produce: that conduct is for us its sole

significance. He claimed that “the tangible fact at the root of all our thought-distinctions, however subtle, is that there is no one of them so fine as to consist in anything but a possible difference of practice. To attain perfect clearness in our thoughts of an object, then, we need only consider what conceivable effects of a practical kind the object may involve”...”Belief, in short, are really rules for action; and the whole function of thinking is but one step in the production of habits of action.”

The great American philosopher William James took “Peirce’s principle” and through a series of essays and lectures in 1907 fully developed “The Pragmatic Method”. He states “*True ideas are those that we can assimilate, validate, corroborate and verify. False ideas are those that we cannot.*” James made famous the pragmatic method of thinking by applying it to many different fields: medicine, psychology and politics.

One of the great problems of the financial industry is signal noise. There are over 9,000 U.S. public corporations publishing data. There are tens of thousands more worldwide. If we add all of the corresponding options and derivative products to the flow of economic data, there are over a quarter million data series to follow, most of them daily. It requires a pragmatic mind to filter this clutter down to that which is significant, that which can be assimilated, validated, corroborated and verified, thus deriving that which can be acted upon.

To a pragmatic person, all realities influence their thinking, and what influences their thinking, and hence their action, has great meaning. **The most important question that can be asked of an investment manager is “what most influences your thinking, and how do you put this into action”.**

**Mental Discipline and Concentration** are crucial. While the average trustee may not easily examine the exact mental discipline of their managers, a reasonable device can be employed. William James said that (in the mental energy order) “writing is higher than walking, thinking is higher than writing, deciding higher than thinking, deciding ‘no’ higher than deciding ‘yes’”. Thus what a manager says “no” to is much more revealing than what is said “yes” to. Successful managers can articulate their thinking process all the way up to “no”. This reveals much of their mental discipline, and trustees should make that inquiry.

**Personal Confidence** comes with the repetitive attainment of goals. This is as true in financial management as it is in competitive sports military training or surgery. William James was fascinated by great athletes. He observed that the great athletes had a special confidence that they could continually achieve a personal “best”. These athletes just “knew” that they could achieve more: run faster, jump higher.

While on a visit to Switzerland he studied athletes who were ice climbers. The personal danger to these climbers of not jumping far enough over an ice crevasse intrigued him greatly. He subsequently coined the term *precursive faith*, or a faith that

runs ahead of the observable evidence. To the ice climber, turning around to be home by dinner was called a *living option* by James. Jumping a 5' hole to get home was a *forced option*. Having to jump a distance past the climber's personal best to get home would be what he called a *momentous option*. Lance Armstrong suffered a fall mid way in the 2003 Tour de France. He told reporters that after he crashed he had fallen over one minute behind, with his best days probably behind him. After resuming his ride he stated that in his mind he kept repeating "if I am to win the Tour de France, I must do it today". He brought all of his mental discipline to bear, and on that day he achieved his personal best time for that leg, more than making up the time lost on the ground.

**Every** investment manager has experienced one of these option moments. A truly experienced manager has faced these moments in up markets, down markets, manias and panics. They will remember the circumstance that required belief that their personal action must rise against uncertainty, and their action would ultimately bring success. The willingness to act at a maximum point of uncertainty is a measure of confidence. The outcome of the "momentous option" determines greatness. Ask your manager about such experiences.

**Vision and goals** must be clearly articulated and understood. A manager cannot provide superior results to you if they do not have a clear vision of where they are going in their personal and professional life. Steven Covey has written extensively on the issue of principle-centered living, and the trustee should be keenly aware of the driving forces in their manager's lives. Goals are not created equal, but the principles of goal attainment are. To set strong personal goals requires good judgment, and at the end of the day, good judgment is a function of good character. To set and meet strong investment goals is a function of experience, concentration and discipline. All superior managers (in the author's experience) have a clear conception in their minds of what must be accomplished to attain their goals, and can easily articulate this to you. It is the ultimate responsibility of the trustee to insure that the manager's goals are aligned with the goals of the portfolio.

**Passion and Commitment** play a key role in success. Successful managers exude energy and an enthusiasm that you can literally feel. The great finals presenters and relationship managers who interface with trustees have studied the great actors (after all, they do have much in common). Katharine Hepburn was once asked the secret of her success to which she replied simply, "Energy". Presentation energy and enthusiasm has swayed more than one trustee to select an unknown manager. The energy of a salesman to collect a commission should not sway you. It is the passion and the commitment of the investment professional that counts.

**Joy and Enthusiasm** bring success in a variety of ways. Enthusiasm accelerates motivation, which in turn nurtures the natural talents of individuals. One can learn Modern Portfolio Theory, or study to pass the CFA, but without great enthusiasm for not only the science of portfolio management but the art, one cannot be great. While the manager may not have great enthusiasm for your particular mission or institution, great managers receive joy (psychic income) from obtaining superior results. It is this pure

joy in their professional practice that instills a pride which overcomes the temptation to provide a service at less than their full level of competence. The great managers believe they produce a noble service, and no matter how distant, the beneficiaries of their work matter greatly. Personal confidence is the hallmark of many great surgeons, professional athletes, generals and money managers. At the end of the day, however it is the joy of their professional practice that should be observed.

**E**nthusiasm leads all of us to overcome the inevitable adversity associated with investment management. All of us have suffered failures (sometimes quite humiliating), and those who haven't are guilty of not taking the measured risks of the manager with precursive faith.

**C**onsistency of Results is thus correlated to the consistency of behavior, and that consistency, while often hard to find, can be identified. It is the key to viewing the art in management. It is true that success in dynamic environments requires the ability to be flexible and adapt to changing circumstances, and to be creative where appropriate. But consistency means not to waver in resolve, not to succumb to the siren song of noise in the marketplace, and absolutely to maintain a fidelity to personal philosophy.

**T**he computer cannot fathom the personal philosophy of a manager, nor the intellectual organization of the manager's mind and how that philosophy is influenced by personal emotional forces. With thousands of management companies and tens of thousands of employees, it is a daunting task to interpret the statistical analysis of performance let alone keep current on the personal philosophies of ever changing individual managers.

**T**rustees are encouraged to search out and discover more about their managers through a lesser used prism; a philosophic prism. You should know if the philosophy of each of your managers is compatible with and aligned with yours, for you in turn are also a servant of your institution, and there will be a reckoning of your performance.

Geoffrey W. Cutler  
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