Beware the Trifecta of Desire

Douglas Isles, Portfolio Construction Forum, 14 February 2018

How are Your Flows?

"How are Your Flows?" is a question I hear too regularly. It cuts to the heart of the problems we face in communicating about investing. It captures the essence of our biases. These biases affect how you hear our message, but equally, how your clients listen to you.

"How are your flows?"

A simple question. Four short words.

A question about connection. What's everyone else doing?

And while less intuitive, it's ultimately a question about performance.

Performance, Connection and Simplicity.

The trifecta of desire. The trifecta that practitioners I meet with tell me they want, and it's the trifecta that I believe leads to suboptimal outcomes.

Of the three, Performance is essential, but must not be chased. Connection and Simplicity are however "tools of selling" and at odds with "tools of investment". They can be exploited.

Having been an analyst, I started my current role in 2013 by speaking to clients, trying to understand their needs. Essentially, putting Finology into action – investing meeting investors.

Our business had grown without physical presence, reinforcing the ultimate driver is Performance. Other client requests all related to Connection or Simplicity. Hence the trifecta of desire.

We all know our biases affect investing.   But they also compromise investment communication and this can hurt clients.

So the key question is, how can we get better client outcomes?

Today I will help you think about your interactions with fund managers and encourage you to consider your own message to clients and empathise with how it may be received.

Communication is not easy. Last year I stood here and declared “Wall Street has Failed”. Decades of repeating “buy low, sell high” had not prevented millions suffering disastrous outcomes via inflated bubbles and their subsequent busts. Bitcoin is a recent case in point.

“How are Your Flows?” asks “what is everyone else doing?” and while discussing the herd mentality is hardly breaking new ground, our deep desire for acceptance, for “social proof”, is very dangerous. Do we seek others’ approval to invest? Do we want to do the same as our peers? It seems accepted that positive flows are the crowd’s endorsement of a good fund.

But flows do not and cannot predict future performance! This is the recency bias at its worst -> industry surveys and our own data which I will show here confirm that collectively consumers chase past performance. Our flagship fund’s performance is in Navy. The subsequent fund flows are in Turquoise.

The relationship is alarming. Recent past performance is a very strong predictor of flows. I use an algorithm to track this, to help me empathise with clients. I know when people are likely to take money away, or to give us more. But it is volatile – an emotional rollercoaster.

So, “How are your flows?” is really just asking “How was your performance?”

Performance is the holy grail of active management.

There’s a close parallel between picking stocks and picking funds. The same biases afflict us. As fund managers we assess companies and their prospects, and weigh them against share prices. Fund selectors assess the manager, their process and their likelihood of delivering. The advantage with funds is that the goal is to identify good managers. With stocks identifying good companies is not enough, the price determines good investments.

The passive bandwagon doesn’t help. We hear that “on average active managers don’t outperform”. Perhaps, but average golfers don’t break par. Jason Day is proof that some golfers can consistently perform. Disciples of Passive would counter that identifying Jason Day is too hard. Is it really? Finding persistent talent is worth the effort even though investment skill is less visible than sporting prowess.

The key is discerning between process and outcome. We struggle with “false causality”- confusing correlation with cause and effect. The successful San Antonio Spurs basketball team touched each other a lot when they scored so other teams tried to improve their performances by touching each other more!

Our industry focusses on outcomes; good outcomes sell funds, while processes remain conceptual. Regulators know this. There is a good reason for the disclaimer that “past performance is not a reliable indicator of future performance”.

But Performance is based on a single sequence of events that actually occurs. Via this lens, everyone who thought Hillary would beat Trump, or that the UK would stay in Europe was simply wrong – there are no shades of grey, let alone 50 of them.

No one can measure a portfolio in advance. We can’t consider a probability weighted sum of infinite possible scenarios. Worse still, risk analysts use realized historic outcomes to model possible future ones behind a facade of scientific rigour. This is simply wrong.

A successful process is to buy cheap stocks and sell expensive ones. But expensive stocks can rise and cheap stocks can fall. In the short to medium term, sound processes can and often do deliver poor outcomes while poor processes can and often do well.

We suffer from an "illusion of skill". Despite luck's important role we celebrate the "Fund Manager of the Year" and hold single stock-picking jamborees. The low correlation between yearly performance tables renders this futile. Fund Managers of the Year often privately curse awards as peaks in their business.

The "halo effect" explains how we then extend strong performance to all facets of an organization or to individuals. We hail strongly performing fund managers as great presenters, and seek their every opinion while temporarily unlucky managers can seem incoherent.

The lucky get luckier, attract capital, grow their businesses and become more visible. Their opinions seem most valid often just as their luck runs out, and "mean reversion" starts to kick in. No wonder experts' predictions have been proven worthless on average.

To counter this I now track peers' performance simply to know whose opinions are most sought after, knowing I'll regularly be asked if I agree. Normally, I don't!

Another challenge is self-attribution bias. Humans tend to take credit for good outcomes while blaming bad luck for poor ones. Australia avoided the GFC because of Chinese resource demand, not the quality of our leaders; though they may have you believe this! Stock analysts also exhibit this bias, perhaps you do with funds.

The "illusion of control" is a problem, particularly in Australia and it's leading to a race to the bottom on fees. The mantra is while you can't control performance, you can control costs.

Consider how you charge for good advice. Products and services will be priced between their cost and the utility provided. Focussing on price over substance leads to lower quality outcomes. Those with genuine and scarce skill know not to give their limited capacity away cheaply but someone is always discounting to grow. Our businesses are similar- do you prefer fee-focussed clients or those valuing your results?

The simple problem is that the best managers are not always the best short term performers. This distortion causes angst but Portfolio Construction at its heart accepts different assets, funds, or stocks do well at different times. Staying the course is the challenge.

But when performance is softer, when instincts make it harder, when clients start asking questions, that is when the other desires are critical. Connection and Simplicity. But these “tools of selling” are at odds with “tools of investing”.

Think politics – short slogans, repeated over and over again to connect to the electorate in a simple way. Make America Great Again. Think marketing messages – simple slogans, logos, promises, hopes and dreams. Just do It! Think media, shocking headlines to grab our attention. The market plunged again! We are drowning in information, bombarded with data, and we need to somehow make sense of it all. But in doing so, we revert to animal instincts and we become easy prey, for manipulative marketers, predatory politicians and mercenary media moguls.

Let’s dig a little deeper.

Connection is a basic human need. We feel exclusion as acutely as physical pain so fitting in is very important. The herd mentality is well documented but I will contemplate the risks of connected-ness.

Think about the “psychology of compliance” – not the fastest growth area of our industry, but getting people to agree, to come round to our view.

Robert Cialdini is the Influence guru, his books are a marketers' gold. 4 of his 7 "weapons of influence" directly relate to connection - reciprocity, liking, social proof and unity. Strong connections are essential for persuasion, but as listeners, they make us more vulnerable to manipulation.

Every salesperson knows "How to win friends and influence people" –the 1930s book remains a bestseller: Listen, Take an interest, smile, use peoples' names. Above all, avoid disagreement, conflict, arguments. However, most successful fund managers have a contrarian bent, they take the market on…

Bringing an opposing message is a tough starting point. We say "don't shoot the messenger" for a reason – we don't like hearing we'rewrong. People hear consensus opinions frequently, and the "sleeper effect" suggests hearing something often leads to greater acceptance it's true.

But unless a fund manager takes on the market they accept the market is right and If they accept the market is right, an ETF will replace them!

Consider statements like "Apple is a good company" – no-one will disagree; the subtle trick here is a general perception that good companies must make good investments. To win people over as clients many make statements that can't be challenged but which don't help us make money.

Audiences lap up confident forecasts, despite their error rate, they are charmed by halo induced Authority (another Weapon of Influence) and struggle with a bewildering "paradox of choice". At this stage of the cycle new products abound. Shiny new things are a constant trap. Many recent product developments favour promoters over clients. Inducements are soaring despite FoFA and unproven teams are given the benefit of the doubt. Nassim Taleb calls this Neomania – our obsession with the new – and it's a virtuous get rich quick scheme for those with beginner's luck.

So connection is a critical "tool of selling" aided by agreement, while successful investing is often about challenging consensus thinking.

And finally, Simplicity.

Nobel Prize Winner Herbert Simon introduced Heuristic Simplification. Think “rules of thumb” or stereotypes. They helped with evolution given our inability to model all possible outcomes, but they can lead us spectacularly astray.

We’re constantly asked to simplify what we do. But think about your business. If it can be written as a set of simple steps, a computer will do it. That’s your robo-advice, that’s our smart-beta. If a computer can do it, we won’t exist.

Financial markets are abstractions and concepts like indices make it more unreal. At Platinum the process is simply a “continuous energized debate about businesses” – not something a computer can do, but also something that’s hard for clients to conceptualise.

So the industry exploits Personification, Slogans, Familiarity and Story-Telling.

Personification is epitomized by profiling and celebrating Star Fund Managers. Meanwhile evidence suggests funds with multiple portfolio managers generate better results. The importance of organisations over individuals is confirmed in work by Boris Groysberg on Stockbrokers, Klaas Baks on Mutual Funds, and Ben Darwin on sporting teams. Most ambitious start-up managers learn this once beginners luck wears off but genuine investment houses far outlive their founders.

Slogans cut corners and are led by whatever’s hot at the time. Today, the word disruption feels overused, yet it’s been happening since the Industrial Revolution. We hear back, unchallenged, agreeable wisdom that sounds convenient. In 2016, we kept hearing that expensive global companies were the best way to get exposure to emerging consumers, just before Asian markets, filled with local champions, started to perform strongly.

Familiarity is another problem. 27 years without recession has left Australia's extreme home bias, as yet, unpunished. Again, process versus outcome. In our sphere of global investing, many used to ignore overseas stocks, using exporters as their ticket to the world. Today we're starting to see a shift, but it's still shallow. It's what I call the Walt Disney approach to investing. Buy Nestle because everyone drinks coffee, buy Apple because everyone has an iphone or buy Colgate because everyone cleans their teeth. This ignores price, the key driver of returns. Well-known companies are often fully-priced.

Perhaps think in another way. Italians are familiar with their banks, the Chinese with their insurers, the Japanese with their manufacturers and the Indians with their utilities. If these companies are priced cheaply, and if we do enough work, we should be comfortable investing in them. 20 or 30 years in the field makes this easier.

Storytelling has passed wisdom down through generations. However, well-crafted, carefully selected, engaging stock stories delivered by strong and entertaining presenters will often have already performed.

Charlie Munger noted it's hard to separate true knowledge from a learnt show full of eloquent words, phrases and ideas. Jargon is often used to sound authoritative. Ambiguous answers are commonplace but "markets could go up or down from here" is as valuable as a horoscope.

Our love of stories exposes us to "Fundamental attribution error". We allocate reasons for events to explainable packages. Whilst sounding neat, Archduke Ferdinand's assassination, did not, by itself, cause World War I.

People like asking questions that can be answered and tracked. "What's your economic view?" is easier than examining useful but more abstract portfolio characteristics. Simply, a superior portfolio not priced as such will do well over time. That's the goal.

It’s ironic. The best investment decisions are the most uncomfortable. Unless timing’s perfect, they fall before they go up, making them even more uncomfortable. They can be hard to express, uncertainty abounds. Describing them later, they sound logical – like they were meant to be. Only then do they make great theatre.

At the time, they sound crazy, they’re the opposite of what everyone else believes is true.

If we present tough ideas coherently, we don’t convey the angst. Describing clearly why you own a stock gives it legitimacy. Clients sense certainty then feel let down by any alternate path. Simplicity misses the psychology of successful investing.

The hardest part is conveying that our entire existence as active managers relies on a rare talent for exploiting uncertainty, disagreement and complexity. Machines will replace the simple and those who simply agree with the market.

I started thinking about this topic to develop my own role. The more I learn, the more I’m clear the trifecta of desire exposes our biases.

Performance must be sought but not chased.

Connection and Simplicity certainly help but are often exploited.

The 2 “tools of selling” are at odds with the “tools of investing”. And if fund managers focus on these over performance, disruption is inevitable.

Finding a rare and genuine edge in delivering long term performance for clients is the goal of fund selection. To do this you must embrace complexity and diverse views, avoid celebrating individuals over teams, and deepen the focus on understanding the viability and sustainability of organisations and their processes.

To start this journey I encourage you when meeting fund managers to replace the questions of “How are Your Flows?” and “What’s Your Economic View?” with “What is Your Edge?” and “Why will it persist?”

Doing so will lead to more engaged discussions, deeper insights and superior client outcomes.

To help you with this, I suggest a number of publications to help you explore the topics I have raised today in greater depth. This reading is worthwhile. These experts share some valuable and practical concepts worthy of your study. This is what Finology is all about.

And above all, please, Beware the trifecta of desire.