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On the Cover

Zolnay Fig Vase
Iridescent Glazed Porcelain, 1983
7 1/4 × 4 5/8 inches

Eva Striker Zeisel *(born* ***Éva Amália Striker****, 1906–2011) was a Hungarian-born industrial designer known for her work with ceramics after immigrating to the United States. During the artist's 105 years of life, she was successful at being one of the most important industrial designers of the 20th century. Zeisel's accomplishments are included in the collections of the Museum of Modern Art, the Metropolitan Museum, and many others around the world. Eva Striker Zeisel's works can be seen at Schroeder Romero & Shredder Gallery in New York, NY. Visit www.srandsgallery.com to view more works by this artist.*

Despite an assuredly impressive and exceptional track record, Warren Buffet's portfolio construction advice may have been more of a disservice than a service to individual investors. In short, one of his admonitions is based on the principle that one will have very few good ideas over a lifetime; he thus suggests that one should wait for the right one and then take a concentrated portfolio position to profit from it. Consider the following three potential analogs: how many Harvard University college dropouts found a company like Microsoft and thus build one of the top-two fortunes in the United States? How many individuals introduced to golf at the young age of 2 grow up to win the Masters at age 21? How many people win the jackpot at the lottery? One could go on, but the point is made: there are exceptions everywhere, and one should avoid making any projection based on the record achieved by any exceptions. Exceptions do occur, but they are not the rule!

A more rational process, following the advice offered by Daniel Kahneman in his book *Thinking Fast and Slow*, involves going through an analysis of the available data, determining the data's range of applicability and a notion of the naïve probability of something happening, and then drawing the appropriate conclusions based on a comparison between the actual event and what one would naively expect should happen. Rather than looking at the "process" used by an exceptional investor and imitating it because it has worked once, one would take a closer look at how that approach actually worked. One would question whether it involves skill or luck. One would question the kinds of skills needed for that process to be successful if skills are involved. One would then question whether the circumstances at play in that situation can be generalized or are so unique as to make the process unlikely to work for any other investor or at other times. Applying this approach to the case of Warren Buffet might lead one to continue to have a huge respect for his achievement, but to question whether his methodology is readily replicable.

The legendary late Sir John Templeton was very clear on the topic of the likely success of any single investment decision. He simply stated that he had never seen an investor whose probability of success exceeded 65%. Said differently, investors should, according to him, expect to be wrong at least 35% of the time. It follows that there is a real probability of making a number of these wrong decisions consecutively: assuming a 35% probability of failure, there is a 1.5%

chance of being wrong four times in a row. Using a more modest 45% probability of failure—and thus of being right about 55% of the time—the probability of being wrong four times in a row jumps to 4.1%. In short, in the presence of such a risk, it would be rational to seek to ensure that one retains enough money to "go back to bat" after four consecutive errors.

Revisiting the Buffet approach in this more sobering perspective, one might start by identifying the three crucial skills that he must have had to produce his exceptional investment record; note that, at this point, one would argue that such skills are necessary, but may not even be sufficient conditions. The first relates to his ostensible ability to generate exceptional investment ideas. The second relates to his implied ability to differentiate between his exceptional and his ordinary ideas. The third relates to his ability to withstand adverse market circumstances without panicking out of positions that eventually pay off. One could additionally argue that some luck may have been involved, but, in this, he is not alone: great results often reflect innate abilities, hard work, and some luck.

Ostensibly, not everyone has the ability to generate exceptional investment ideas. Clearly, such a feat is possible, from time to time, through sheer luck. Yet, the probability of being wrong when luck is the main driver of insight jumps to 50% and the advice offered by Warren Buffet is even more dangerous. However, there are individuals who have such unusual skills, which typically require a mix of solid macro-economic, accounting, and financial insights; an ability to determine what the balance of the investment community thinks; and the fortitude to take a position that can be substantially at variance with current accepted wisdom. Additionally, solid investors typically also have the ability to perform "derivative thinking," which can be defined as the ability to take an idea and identify all the different ways in which it can impact markets; then, the process comes back to finding which of these ways is least understood by market participants. A simple example of this starts with the view that oil prices will go up. The first logical step would then be to seek to buy oil or oil futures. Yet, there are many other ways to "play the theme:" one could buy oil-producing companies; one could buy companies that supply equipment needed for the production of oil; one could buy companies that supply equipment needed to explore for more oil; one could also elect to sell companies that manufacture petrochemicals, as naphtha—one of the products of oil refining—is the feedstock for the petrochemical industry. Focusing on a distant derivative idea of an original theme is a proven manner to generate value added even if the theme is not totally original: traders prefer direct plays, whereas investors can look for indirect, but better, approaches.

The most classical error in this space involves investors who think they have unusual investment insights because they follow the advice of someone (in the singular or in plural) who is smarter than others. We fall here in the domain of the "availability heuristic" well described by Daniel Kahneman in the aforementioned book. Though it involves a much broader array of situations and concepts, the point here is that an "event which attracts attention will be easily retrieved from memory," in Kahneman's words. The error is that when retrieval is easy, people might be tempted to think that the class is large or that the event is representative or even significant. Indeed, how many individuals, who are tempted by the idea of following a portfolio approach because of a few successful model investors, have forgotten or ignored that, for the few who have been successful, there may have been many more who failed because these failures hardly make headlines. Combined with our current epoch's tendency to privilege sound bites and headlines over detailed analyses, this focus on an advisor's exceptional record can be woefully misleading, if not worse, for investors who do not appreciate that their advisor may or may not have exceptional skills.

The second element is the most insidious. It involves assuming that one can tell the difference between one's own good and bad ideas. Indeed, the fundamental probability of the success argument suggested earlier starts with the principle that all decisions are independent and equally likely to be successful. Yet, it is not terribly surprising to think that there are ideas on which one has a higher level of conviction than others. The main intellectual challenge here is not to differentiate between conviction levels, but to be able to demonstrate that higher conviction ideas tend to be more successful than others! Individuals often allow themselves to be fooled by a combination of narrow framing, hindsight biases, and overconfidence. Behavioral finance literature describes very well how these three personality traits—which are all part of an individual's makeup—fool us into tending to extrapolate the recent past into the indefinite future, remembering our successes and forgetting our failures, and thus of thinking that we are more skilled than we are. Add the illusion of control from which we all suffer, and the explosive cocktail is ready!

Experience suggests that the link between conviction levels and success is not terribly strong, if it exists at all. In fact, and unfortunately for the self-esteem of most investors, most studies seem to suggest that very few people have unusual insights and even fewer can a priori distinguish between their good and bad ideas. An unrelated, but still interesting, point to mention at this time relates to what has been called the curse of the taxable investor. Taxable investors indeed tend to be hurt twice by their poor decisions. First, assuming a positively sloped capital market line, they probably had to realize a capital gain—and thus pay taxes on it unless they had some form of tax loss carry forward. In that context, they effectively "paid taxes for the benefit of making the wrong decision." Second, recognizing that a bad idea does not necessarily lose money—it can simply be a lesser performing investment—they may have to pay taxes again when they realize a capital gain to extract themselves from the "losing" trade. Humility and tax realities would therefore tend to suggest that very few people should follow their instincts vis-à-vis high-conviction ideas.

The third important skill, which an investor who believes in a few concentrated positions must have, relates to the ability to tolerate potentially significant marked-to-market losses on the way to future gains. Mark Hulbert, in a *Forbes* article dated October 23, 1995, makes this point quite eloquently. He writes that the recommendation that "investors should focus on equities because they perform better than bonds over the long term" may be the worst possible advice that can be given to investors. He notes that "you can get run over by a truck on a highway which averages only one truck per day—especially, if you panic when it arrives." This decision risk is very important, as we all tend to feel uncomfortable with losses, even if unrealized. In fact, this echoes the Bernstein paradox, which argues that investors should wish for prices to fall for as long as they are in the position to add to their portfolios, and to rise when they need to live off them. And yet, most investors are more comfortable "buying on the way up" and "selling on the way down" than the opposite.

In short, one is left with the view that Warren Buffet's advice is probably only valid for the rare individual with a similar skill set. For most of us, following his advice could have devastating consequences. It is, therefore, probably worth repeating three key principles that individual investors should remember:

1. Wealth is typically created in entrepreneurial ventures; public investments should be viewed as able to protect wealth in a dynamic sense—against inflation for instance—but not to create it. Ostensibly, there are exceptions to this rule, but these are few and far between. In fact, it is often noted that the greater destructor of wealth in families is excessive risk or momentum investing. In the former, families tend to sell risky assets after a meaningful market downturn—often not too far from the point of maximum pain, which typically hovers around market bottoms. The latter involves adding risk to a portfolio after a significant market upturn—often not too far from the point of maximum euphoria, which typically hovers around market tops.
2. Successful investors tend to make a large number of small decisions rather than a small number of large ones: they have the law of large numbers working for rather than against them. Though this can appear considerably less glamorous an approach than one relying on concentrated positions, it will typically tend to be more successful. Charles Ellis, in his seminal book entitled *Investment Policy*, likens investing to a game of tennis. He then goes on to argue that the major difference between amateurs and professionals is that amateurs lose points, while professionals win them. Many other sporting analogies can be used, but they all point to the same conclusion: assess fairly the situation and react to it in the appropriately measured way according to your skills.
3. Successful investors tend to know what risk they are taking. Over the long term, the main driver of portfolio risk is strategic asset allocation. Investors should thus be fully in control of that decision; recent advances in goals-based investing offer an opportunity to do this with relatively little need for unusual mathematical or financial skills. Portfolio management around that policy rests on two decisions: tactical strategy allocation in response to perceived over- and under-valuations in the marketplace and manager or instrument

selection. The former has a lower probability of success than the latter, as it involves fewer decisions; it therefore tends to add value in a lumpy manner and to induce material tracking error. More importantly, it has the potential to be even harder to implement in taxable portfolios for the curse mentioned earlier. The latter relies on a number of small decisions and can thus more regularly add value. However, one needs to remember the need to distinguish between markets based on their relative levels of efficiency and concentrate manager or security selection risk taking on strategies that have a reasonable chance of capturing real rather than perceived—or, worse, hoped for—opportunities.

Investment management is a highly fickle discipline. There is plenty of room for successful managers or investors to prosper. However, those who do so typically have learned the need for a solid dose of humility. They will therefore adopt investment processes that rely on measured decisions and possess a high degree of discipline, to maximize the chances of providing value added over the long term. While they may seem "wimpy" at times because they are less spectacular or aggressive than others, they should be judged over a time horizon that gives an opportunity to distinguish skill from luck. Occasionally, a Warren Buffet will come forth and confound "theory." These exceptions should be admired, but not copied.

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The Fall 2012 issue of *The Journal of Wealth Management* starts with an article by Joachim Klement and Robin Miranda, which tackles the difficult issue of explanations for the diversity of risk preferences among individual investors. The authors review research in neuroscience, genetics, and behavioral decision making that underscores the importance of experience in financial risk taking and they argue that not only individual experience influences risk taking; so does the collective experiences of groups.

The next two articles relate to new investment strategy insights. The first, by Paul Bouchey, Vassilii Nemtchinov, Alex Paulsen, and David Stein starts with the observation that volatility affects how returns compound over time and argues that it is possible to profit from volatility. It explores the concept of volatility harvesting, or the extra growth generated from systematically diversifying and rebalancing a portfolio, which suggests that this excess growth is available in liquid markets with assets that have volatilities greater than zero and correlations less than one, and observes that only investors with the discipline to trade systematically will harvest this extra growth. The next article, by Haim Mozes and Serge Cooks, provides evidence that market timing is possible over the shorter time periods that institutional asset allocation approaches typically consider; this evidence is based on the performance of components typically used in quantitative market-timing approaches as well as on the authors' finding that hedge funds have successfully practiced market timing over the past 20 years and that market timing is the source of at least half of hedge fund alpha.

The next two articles focus on the generic topic of alternative assets, more specifically on the so-called hedge fund space. The first, by Jean Brunel and John Elmes, starts by observing that so-called hedge funds have not met performance expectations in recent years: Performance in 2008 and subsequent years, for instance, has suggested that downside protection may be less than expected; that liquidity may be less than anticipated; or that absolute returns may actually be negative! Looking in more depth at performance against more appropriate benchmarks and screening away a large majority of the universe, they find that the industry has matured, and that, though the industry as a whole may no longer benefit from the tail winds it enjoyed for a long time, there remain a number of strategies and managers where material value added is available. The second, by Panagiotis Schizas, uses a sample of five funds of hedge fund indices from 1999 to 2011 to characterize their risk and return profile and then examines the performance of these indices for a sample of different periods before, during, and after the subprime crisis. The results show substantial differences in the actual mean returns, the actual risk, and the Sharpe ratio. Furthermore, it found a positive relation with the stock market before and after the crisis, and a negative relation with the volatility factor during the crisis of 2007 to 2009.

Our final four articles cover a very wide spectrum of issues. The first, by James Chong, William Jennings, and Michael Phillips, introduces a macroeconomic factor model, the Eta® model, and its various applications; the model's underlying message, be it for replication, wealth maximization, or wealth preservation, is that "The Economy Matters." The second, by Olivier Mesly, Jean-Pierre Lévy Mangin, and François-Éric Racicot, discusses the notion of perceived predation and reveals some of the key findings following a study conducted with three different groups in 2011. The study shows that untrained people invited to negotiate financial transactions with another party naturally tend to adopt a strong stance whereas those with training in negotiation adopt somewhat of a more conciliatory attitude. Colin Read, the author of the third article, focuses on the MF Global bankruptcy, documents some of the relevant financial history of the failure, and outlines the various market failure theories it invokes. Our last article, by Mahmoud Haddad and Sam Hakim, analyzes the role of domestic and foreign banks in Saudi Arabia during the latest financial crisis that has ravaged the world since 2007. Although there is a suspicion that partly owned foreign banks are more risk exposed than their purely domestic counterparts, their findings suggest otherwise, leading them to conclude that the evidence does not support recommendations for a double standard in banking regulation.

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Editor