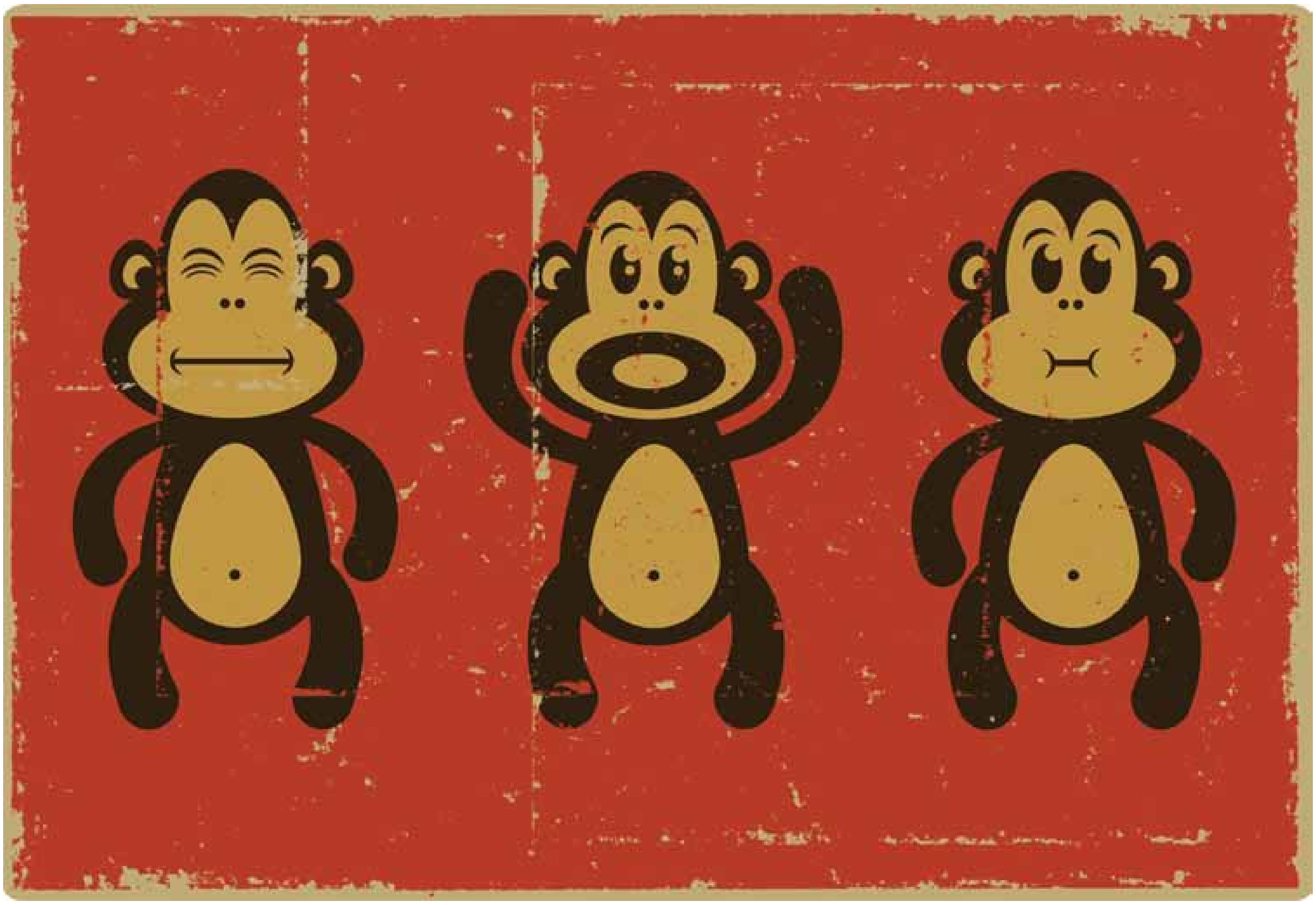


Good as gold, safe as houses: why smart funds managers avoid clichés

Bad investment performance is detrimental to funds management businesses. So is being one of many look-alike managers, write DANIEL GRIOLI and MATT MILGROM.

Printing the news in the old days of moveable type was hard work. Multiple lines of type were slotted together letter by letter to produce complete pages. Printers noticed that certain words and phrases were used frequently. Ever keen to take an early lunch, they realised that instead of assembling these letter by letter each time, they could be cast into single slugs of metal and grabbed whenever needed.

And so the "stereotype" was born, colloquially known in French as a "cliché", allegedly after the "clicking" sound of a printing matrix being dipped into molten metal.

Today, with computer typesetting having long replaced moveable type, the cliché is, ironically, more prevalent than ever before. Safe and convenient, the cliché is still king in the risk-averse kingdom of investments. Unfortunately, the price of circumspection is lazy thinking and missed opportunities.

Sadly, when superannuation funds and asset consultants assemble portfolios, they face having to differentiate between dozens of look-alike funds with apparently identical offerings. Avoiding investment clichés and demonstrating the intelligence behind your fund will truly help you stand out in a crowded marketplace.

Minds for hire

It may sound overly simple, but a super fund or consultant essentially buys one thing from a funds manager: their thinking. Fuelled by a unique blend of education, hard work and market experience, this thinking flavours everything a funds manager does - their investment decisions, asset allocations, stock selections and portfolio construction.

So logically, funds managers that want to stand out from their peers should showcase the thinking behind their investment philosophy, process and performance. Clichéd thinking, however, will do precisely the opposite. What is clichéd thinking and how can a funds manager get past it?

Chemical clichés

The brain is a fascinatingly efficient neural network. It doesn't simply store and retrieve information like a purple fleshy hard drive. As described in the book, *The Mechanism of Mind* - written by the father of lateral thinking, Edward de Bono - the brain is an "active" information storage system. That means that it allows the flow of incoming information to form channels, rather like rivers collecting water within a large catchment area. Using these chemical channels, the brain is able to categorise a vast volume and variety of external stimuli and then come to appropriate conclusions.

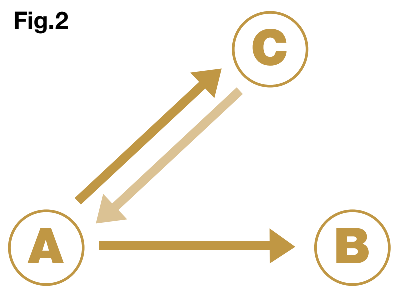
Of course, without this dynamic chemical "shortcutting", everyday life would quickly become enormously burdensome. Conversations would play out like laborious games of chess with every possible meaning and response thoroughly analysed. Instead, we quickly connect a thought (Point A) to a logical conclusion (Point B) without being sidetracked by other, lesser possibilities. (See figure 1.)

Fig.1

As efficient as it is, however, this kind of linear thought process is the enemy of the creative thinker, simply because it tends to eclipse alternatives. Other conclusions - and that includes those that make more business sense - don't make it as far as conscious thought, simply because they are new. However, when recognised, a creative but logically valuable alternative approach is delightful, stops us in our tracks and moves us to action. In fact, it's how the best advertising works.

Non-linear thought is also at the core of most humour, which helps us explore what happens with original thought. With many jokes, the listener is led down an expected A to B pathway. When the unanticipated punch line is revealed (Point C), the mind rapidly traces it back to Point A. Suddenly, the mind discovers a conclusion that it is as logical and valid as Point B. The unexpectedness and intelligence behind this (now clear) link amuses us. (See figure 2.)

Fig.2



Better-than-average

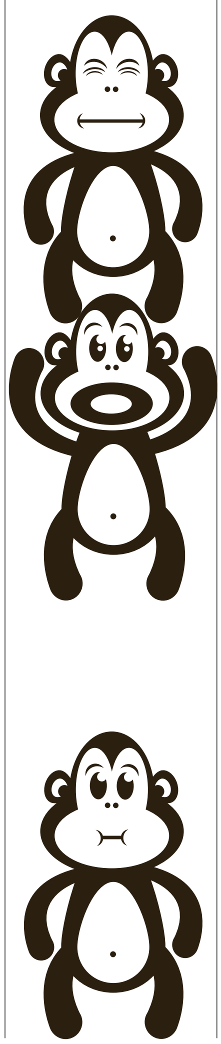
A clichéd investment idea flows easily along mental channels that are already well worn. The conscious mind comes to a conclusion with the minimum of processing. A lazy thinker will confuse that feeling of familiarity with low risk. An innovator will seek to move beyond these obvious connections to seek alternative, equally valid conclusions.

Thinking becomes clichéd when it represents average or popular opinion. And for this very reason it's the polar opposite of the kind of thinking required to deliver superior investment performance. Value investor Sir John Templeton famously said: "It is impossible to produce a superior performance unless you do something different to the majority." It follows that for investment returns to be better than average, the thinking behind the investment decisions has to be better than average.

It is an often quoted truism that with investment, no rule always works, the environment isn't controllable, and circumstances rarely repeat exactly. A successful investment approach needs to work with uncertainty. It's intuitive and adaptive, not fixed and mechanistic - which is why clichés are dangerous. Clichéd thinking leaves little room for investors to adapt their thinking to new information. Rapidly taking the shortcut from A to B, investors form an opinion about the future without thinking deeply or without challenging the underlying assumptions.

So how can funds managers avoid clichéd thinking and grab the attention of super funds and investment consultants?

> **"Clichéd thinking leaves little room for investors to adapt to new information"**



Second-level thinking

Howard Marks introduces the concepts of first- and second-level thinking in his book, *The Most Important Thing:* "First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future." Marks goes on to add that: "First-level thinkers think the same way other first-level thinkers do about the same things, and they generally reach the same conclusions."

Second-level thinking, by way of contrast, is perceptive and insightful. With the application of a little effort and discipline, it identifies the things others haven't thought of or missed, and it brings insight they don't have. The second-level thinker reacts differently to the crowd, and knows exactly why. Knowing that the future is uncertain, they think in terms of range and likelihood rather than in absolutes. Rather than simply making unconventional investment decisions, the second-level thinker fosters an approach that isn't confined by convention and that is open to new information. For example, the United States was recently downgraded by S&P (Point A). (See figure 2.)

First-level thinking (Point B): "This will result in yields rising as investors rush to sell out of Treasuries."

Second-level thinking (Point C): "This downgrade isn't a complete surprise. The market for US Treasuries is the largest, most liquid bond market in the world. Investors will buy Treasuries, as there are relatively few alternatives that can accommodate a flight to safety by risk-averse investors *en masse*."

In this example, second-level thinking allowed the investor to consider the possibility that panicked investors would be happy to receive negative real yields, despite this being irrational from an investment perspective. As a result, the investor would have a choice: either adopt a long-term consensus view and be short US Treasuries; or adopt a short-term tactical position and be long US Treasuries in order to profit from the seemingly irrational market behaviour.

Conclusion

The best way for a funds manager to stand out is to demonstrate perceptive, insightful and - most importantly - profitable thinking. Super funds and consultants need to understand how a funds manager thinks, because it helps them to form expectations of how they will invest and therefore perform in the future. These expectations include answering important questions (see Figure 3).

The answers to these questions allow investors to visualise what their portfolio will look like if they include the fund. And managers can make that process painless for funds by answering these questions clearly.

This is where innovative and profitable thinking provides an edge. Besides providing something novel, superior investment performance comes from doing things differently to the majority. Focusing on profitable ideas that drive asset allocation, stock selection and portfolio construction will help you.

FIg.3 Answer these questions, and spare the jargon

- Given a funds manager's underlying thinking, how would this fund invest and perform during a bear or a bull market?
- What does the thinking behind each investment decision reveal about the funds manager's approach to managing risk?
- What will this fund bring to my portfolio? How does it compare to my existing investments?
- What risks will my portfolio be exposed to if I invest with this fund? Does the fund's risk and return profile match the needs of the portfolio?

Daniel Grioli is an investment analyst and commentator

Matt Milgrom is a key principal at Tender Success