

What *Types* of People Should Manage and Oversee Your Money?

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Introduction

The past decade's financial crises triggered a modicum of industry self-criticism, though largely within the framework of economic rationalism and market fundamentalism. A few have re-thought why models failed, how to view and assess risk, how to allocate across and within asset classes, capital structures and strategies, whether equilibrium prices of asset classes have changed, whether some 'laws' of economics have been repealed and, on the margins, whether the current state of capitalism - Minsky's 'Money Manager/Banker Capitalism' - is fit for purpose. One topic yet to be re-thought is what *types* of people are fit for purpose? What temperaments should we seek and enhance? More operationally, what characteristics should we develop in those we select and promote?

The inchoate thoughts below might edge us towards more considered judgements about what types of people should, and what types should not, manage, advise on and oversee our money.

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Nebraskan Wisdom

Warren Buffett asserts that high IQ and investment success are not well correlated. For those with a high IQ he suggests a trade to increase investment success: Swap 20 IQ points for a *better temperament*. Would that there was a market for executing that trade.

Again the Sage of Omaha challenges an industry shibboleth, and again the challenge will be ignored or dismissed as impractical, as “Warren being Warren.” That’s unfortunate because lurking behind his folksiness lies a profundity others too have hinted at. Buffett’s teacher Ben Graham declared that, “The main point is to have the right general principles and the *character* to stick to them.” Baupost’s Seth Klarman poses a pithy first filter for value investors: “Ultimately value investing needs to fit your *character*. If you’re predisposed to be patient ... appreciate the idea of buying bargains, you’re likely to be good at it. If you have a need for action, if you want to be involved in new and exciting technological breakthroughs ... you’re not a value investor, and *you shouldn’t be one*.” Managers, advisers and boards could do well to mimic this crude template for other investment areas and styles. For instance, “Ultimately venture capital investing needs to fit your *character*. If you’re predisposed to be patient ... appreciate the idea of the new-new thing, you’re likely to be good at it. If you’re not a long-term thinker; if you need short-term results; if you want a comfortable life free from the pain of *learning* ... you’re not a venture capital investor, and *you shouldn’t be one*.”

Four questions might help transform such admittedly simplistic templates into meaningful filters.

1. Which characteristics of high IQ inhibit and which enhance investment success? IQ does predict success in complex technical problem-solving, a skill that probably transfers to many areas of investing, but Buffett’s assertion is that rarely will that necessary condition also be sufficient.
2. Which characteristics of temperament inhibit and which enhance investment success? A tough decisive temperament is crucial in much investing but as with most temperamental traits it is only tested when under pressure. John Meriwether (in)famously had it until confronted by two Nobel prize-winning specialist technocrats with stratospheric IQs.
3. Do these characteristics vary across asset classes and strategies? Does success in emerging listed equity investing have any temperamental drivers in common with success in developed world direct commercial real estate investing? The temperament of long-only equity managers is likely to be almost orthogonal to that of short-biased managers. Testable hypothesis: The former are relatively uncritical and strongly optimistic (a temperament re-enforced by a sales culture) while the latter are sceptical and largely pessimistic.

4. How do we recognise and develop those characteristics? IQ testing and (costly) psychological profiling have grudgingly become *de rigueur*, often only to appease HR consultants, while anecdotal evidence suggests that admission to finance and investing is granted almost exclusively to those classified as INTJ (Introvert, iNtuition, Thinking, Judgement) on the Myers-Briggs Type Indicator and that very few ESFP types (Extrovert, Sensing, Feeling, Perception) survive.

Temperament and Character

The OED defines *temperament* as “a person’s nature especially as it permanently affects their behaviour; from the Latin ‘temperamentum’ correct mixture.” What then are the “correct mixtures” for investors and their organisations? Temperament, being unmeasurable, is likely to be both important and ignored, yet in politics, warfare and sport where ambiguity and uncertainty are also high its importance has long been recognised. Echoing Buffett’s claim, FDR was once described as having a “first class temperament and a second class mind”. The temperament to craft stable coalitions from unlikely groups was a key to his success, not raw intellectual power. Churchill’s temperament and character were superbly in phase with conflict and war, but inappropriate for almost everything else he tried. The Australian conservative party once had as a leader a successful investment banker and barrister, professions to which his temperament was as well-suited as it was ill-suited for political leadership. Partly *because* of his high IQ he had little patience, he knew not how to form coalitions nor how and when to compromise. Trotsky’s temperament was ideally suited to the post-revolutionary chaos in which he transformed a disorganised rabble into the fearful Red Army, but was ill-suited to the (relative) order that eventually prevailed. Eisenhower was neither tactically nor strategically brilliant but he had the temperament, especially a subdued ego, to lead and direct the unmeasurable egos of Patton and Montgomery. While the strong *functional* parallels between investing and warfare - low signal-to-noise ratios, time imperatives, a mix of strategy and tactics and, as Napoleon well knew, immodest doses of luck - are well-known, perhaps of greater value are the *temperamental* parallels implicit in Norman Dixon’s *On the psychology of military incompetence*, a tome that should be compulsory reading for all who manage, advise on or oversee other people’s assets. In sport temperament and character can apply to entire teams, some of which call on reserves of character to reverse seemingly unwinnable positions.

Depending on the type of investing, successful investors are likely to have a substantial number of the temperamental traits below. They are likely to:

- Possess a somewhat paradoxical blend of arrogance, to discover inefficiencies and arbitrage opportunities ahead of the market, *and* humility to simultaneously be sceptical about those very discoveries.

- Practise the Oracle of Delphi's admonition to "know thyself" which entails recognising one's biases and actively hedging them. For instance, the Oracle would know to hedge the risk that previously justified contrarianism had degenerated into current unjustified stubbornness. Similarly, an investor aware of being over-endowed with the endowment effect would hedge the 'sunk-cost' risk by selling down or abandoning a failing investment.
- Be able to make effective decisions under conditions of extreme uncertainty, ambiguity and pressure. A temperament that seeks comfort and stability will likely be ill-suited to those conditions. The CEO of Procter and Gamble recently declared how he didn't "need people around to exert pressure on me. I exert enough pressure on myself." The unsubtle message may be less damaging in a consumer goods company than in an investment organisation, but damaging it will be.
- Encourage fruitful dissent and debate yet know when to decide and when to execute. Almost by definition all *organised* human endeavours have at their core a paradigm of broadly agreed beliefs, stylised facts and patterns of thought that collectively impose a uniformity of views. Those who challenge the paradigm and so make management more difficult are rejected or ignored by the tribe: Markowitz's thesis was not rated as genuine economics, Bachelier's paper lay buried for 60 years and Black-Scholes' paper was twice rejected. By temperament and selection and re-enforced by training, most investment professionals see the world through the belief-myth that the essence of investing and finance is a form of engineering, as reflected in the common appellation of 'financial engineer' and the theory and practice of portfolio construction. Greenspan reinforced that belief-myth with his 2004 claim that the financial system is now stable and self-regulating (through negative feedback loops), resilient to shocks and foremost that it yields to the power of our intellect, our analytic reasoning, our modelling and our efficient execution. Investment professionals and advisers continue to act as if their tools and mental models empower them to control the beast of uncertainty, or at least tame it by measuring and naming it as β or *CVaR*. The financial crises brutally reminded us how the world is not as we wish it to be, so much so that even Greenspan recanted ... somewhat.

Tribal barriers to productive dissent and debate are magnified by hierarchical, compartmentalised organisational structures, propagated by three forms of asexual reproduction: training, hiring and promotion, and re-enforced by a society-wide belief in omniscient leaders.

- Encourage having truth spoken to them, a trait that calls for frank admissions of ignorance and confusion. Leaders and experts should admit to suffering from time-to-time from the quite common Imposter Syndrome, the sense that one's knowledge, power and career are built on ephemeral foundations and that one day a tap on the shoulder will expose them as a fraud.

- Know when and how to co-operate, a desirable trait but rare in cultures that imbue competition with religious status. Much (but not all) investment information is 'non-rival' whereby its value can *increase* through sharing and co-operating as evident in a multitude of open source ventures such as *Linux*. Yet thanks to temperament, training and organisational incentives many are antithetical to sharing. One study engaged students in a prisoner's dilemma game where participants do better by co-operating. In general 60% of students co-operated but only 40% of economics students did so.
- Value patience and be able to resist the short-term imperative and its eternal concomitant, being busy. The bias to action, to always (being seen to) be doing something on keyboards or phones is a hangover from a pre-industrial age when work was physical and meant doing something with our hands. In the knowledge age, most work is intrinsically sentient, so the default imperative for investors as distinct from traders should be *don't just do something, sit there*. Some are doing that by turning off BlackBerries iPhones, Bloomberg terminals, emails and other distractions that induce anxiety and hyperactivity, the antithesis of successful long-term investing.
- Be curious and questioning, attributes lacking in too many boards that oversee other people's money. After being embedded in US pension funds the anthropologists O'Barr and Conley reported "a surprising lack of interest in questioning and surprisingly little interest in considering alternatives." In a recent survey one pension fund CEO observed that his board proudly proclaims its harmony, a sure sign of minimal questioning and dissent and, as the CEO himself observed, an attribute not necessarily correlated with doing the best for members.
- Create a pervasive sense of trust. In an industry where quality can never be tested, where half a century of performance is needed to distinguish skill from luck, trust is all we have had. One reliable indicator of trustworthiness is a sense of responsibility beyond self and beyond one's employing organisation. Such an external responsibility defines a *profession*, as it does in principle in medicine through the Hippocratic Oath, in law through *pro bono* work for the courts and even in accountancy where the stated first responsibility is to preserve the integrity of the system. Its absence eases the path to unethical behaviour.

Not so Rational?

A lack of external responsibility flows directly from the dominant paradigm that markets behave *as if* economic agents (never ever called people) have fixed preferences embedded in their utility function, and that they make rational decisions by maximising expected utility. Sixty years ago the Nobelist Herbert Simon injected a dose of realism by showing how people are at best *boundedly* rational; they have *variable*

attitudes, not fixed preferences; and they don't optimize but rather make decisions that *satisfy* and *suffice*, they *satisfice*. That form of decision-making requires a temperament different to that of rational optimisers. Peter Bernstein, a powerful thinker and successful investor, clearly saw the consequences of selecting people steeped in the quantifiable scientific culture of our age, "Today's obsession with risk management focuses too intently on the *measurement* of risk. All too often, reason cannot answer ... what matters is the quality of our decisions in the face of uncertainty." With blunt force Danny Kahneman puts the case against our over-belief in rational planning and thinking, "We think we do things guided by reason ... in fact we're guided by intuition ... *We're not made for this world*. We're built in such a way that we systematically misunderstand and under-estimate (its) uncertainty." Yet we crave certainty and comfort. Hegel's insight that we "readily sacrifice conscience and consciousness for it" finds expression in institutions and regulators obsessing about (the supposed certainty of) process as a substitute for "quality decisions", the inherent danger of which was highlighted in the 2012 Report on UK Equities. Its author, John Kay, witnessed "assessments based, not on whether decisions are any good, but on whether they were made in accordance with ... an appropriate process. We assume, not only that good procedure will give rise to good outcomes, but also that *the ability to articulate the procedure* is the key to good outcomes."

Of necessity much decision-making under uncertainty in politics, war, business, investing and personal relationships takes the form of satisficing or of "muddling through", albeit informed by boundedly-rational planning. The US Treasury muddled through effectively after Lehman Bros; they had no alternative as decision-makers were pounded by events, *aka* unexpected exogenous shocks of unknown unknowns. When the British Prime Minister Harold Macmillan was asked what caused him the greatest difficulties, his reply, "Events, dear boy, events", underscored the need for a temperament and a talent for intelligent, informed muddling through. Angela Merkel has both. Her temperament has three likely sources. First, being a woman she probably has the emotional intelligence needed to deal with individuals and groups. Second, being raised in East Germany may have taught her the art of muddling through in a society where that was probably the only way to get anything done. Third, her training as a chemist provided her with scientific but not necessarily quantitative patterns of thought most suited for satisficing and informed muddling through. She would make a first-rate chair of an investment committee.

Hedgehogs and Foxes

Complexity begets specialisation and ever finer divisions of labour, both of which come at the cost of a loss of high-level holistic insights. The more narrowly focused and technical an area the more likely highly specialised thought patterns are the accepted norm, justified by an unarguable need for deep technical mastery.

The frozen chicken industry probably has little need for broad generalists let alone visionary thinkers. Narrow, specialist technical problem-solving training may well be both necessary and sufficient to run an efficient chicken business. Medicine favours an ever finer division of labour, largely to patients' benefit. Narrowly-trained specialist surgeons who repeat the same operations many thousands of times have the highest success rates, a pattern likely to apply to credit portfolio managers but in far weaker form because the signal/noise ratio of the surgeons' operating environment is sufficiently high for past performance to be an excellent predictor of future performance. Lawyers, many (though far from all) of whom by selection, temperament and training exhibit uniform patterns of thought and behaviour, dominate representative assemblies and regulators. And it shows in our overly compliance-driven, legalistic, rules-based culture which in investing inhibits risk-taking and forthright communication.

Specialised thought patterns are less accessible to informed criticism by non-specialists which leads to weaker risk management through unjustified over-confidence by experts, a loss of integrated holistic views and a loss of information that can be squeezed from interactions between different specialists. The greater informational asymmetry also makes it increasingly difficult to intelligently select an expert. How should non-expert patients and their more informed GPs select a specialist neurosurgeon, and how should trustees and their more informed consultants and CIOs select a specialist convertible Eurobond hedge fund manager?

The demise of generalist physicians who monitored each patient's entire body of illnesses and complaints left a costly health gap. So it is in investing. When balanced funds ruled, at least *in principle* asset allocators integrated specialist information into a holistic risk framework across asset classes, strategies and macroeconomic views. Their demise left an unfortunate and costly investment gap that *inter alia* contributed to systemic instability by weakening the arbitrage mechanism between asset classes. Diversified absolute return funds and macro hedge funds are re-filling that gap.

It would be outrageous to suggest that specialist technocrats are automata who make identical decisions and never question and criticise. Nonetheless the universal 'explanation' of the July 2007 quant crisis hints at exactly that. According to that narrative, the uniform training and homogeneity of quants' patterns of thought resulted in destructively crowded trades and lack of liquidity. Yet one study of a large number of quant equity funds found that their stock *rankings*, the purest representation of a portfolio manager's views, 'overlapped' only modestly. By way of contrast, their *portfolios* 'overlapped' substantially, probably due to the demands of agents - consultants, regulators and business managers - who, under the banner of risk-control, imposed uniformly similar constraints on size of holdings, liquidity, industry diversification, tracking error, volatility ... from which optimisers homogenised dissimilar rankings into similar portfolios. Still, it is the case that questioning and criticism within specialist groups is largely confined to technical issues, leaving broader strategic issues insufficiently criticised, questioned or even recognised. In the

aftermath of *systemic* failure we have an inkling of the dangers of a too narrow and specialised vision and of the need for holistic, integrative thinking.

Isaiah Berlin bequeathed us a crude but useful typology of people: hedgehogs view the world through the lens of a single defining and usually substantial idea; foxes view it through multiple lenses. Both types are needed in investing but problematically we are over-populated with hedgehogs that better fit compartmentalised corporate structures and are more fecund. We need more foxes - people with broader perspectives willing to trespass (a notion coined by Albert Hirschman) into and learn from foreign fields. No investment organisation would hire a sociologist, yet Winslow Jones who created the first ever hedge fund was one. Jim Chanos, a famous short-seller, hired an art historian who became one of his best analysts. "She had no formal business school training. She was so good because she was very intellectually curious. She was never afraid to ask why ... This is almost something that you can't train." The Bank of England showed similar courage in seeking insights on complexity from a theoretical biologist, recognising that markets behave more like evolving, adaptive non-stationary biological systems than stationary physical engineering systems. A few investment firms do hire against the stereotype. One US manager won't even consider anyone with an MBA, a CFA or an actuarial degree on the grounds that they've been trained and conformed rather than educated and informed. *Stereotypical* actuaries have a poor temperament for investing and ironically for risk management. By training and temperament they have an abiding tendency to over-emphasise and over-value that which can be quantified, as if calculation reveals truth. While ruthlessly excluding them is a crass filter, its spirit is sensible. Another investment manager adopts a more nuanced selection process. Filter 1: The person must have a PhD as evidence of a capacity to think at high and creative levels and to complete. Filter 2: The PhD must *not* be in finance or related disciplines, which excludes those trained within the dominant paradigm. Filter 3: The person must be capable of expounding intelligently and sensitively on their thesis to an audience ignorant of the topic. That signals passion, coherence and an ability to explain complex notions to non-experts.

Foxes will be spurned and excluded by tribal hedgehogs and branded as soft-headed dilettantes. A cultural change is needed to recognise, support and reward the value they add, often implicitly through their different mental models. Charlie Munger sees having such models as *the* most important things in investing because they expose new opportunities and drive a dialectic of risk. Investment organisations should actively seek more people who have, as the psychologist Liam Hudson phrases it, "contrary imaginations", people who may not perform brilliantly on traditional IQ and other analytic-biased tests but who have exceptional intelligence in meaningful but alternative ways. We need people with intelligence about the humanities, especially history and psychology, the non-quantitative disciplines that underlie and drive markets. We need people with emotional intelligence to direct and manage others, and those with organisational intelligence to get things done. The latter are rare in part because we are all trained under the standard economic model that idealises companies as rational profit-maximisers populated by *homo*

economicus, a model that handicaps us when faced with real companies. The anthropologist and investment banker Karen Ho paints a more realistic picture, “Capitalist organisations are not simply motivated by ... profit or governed by rational actors. They are *sociocultural* organisations with complex contradictory world views.” Getting things done in such organisations requires a temperament different to that required in ideal ones.

Conclusion

Investment managers, corporate and pension boards and consultants should see mental and temperamental heterogeneity as an imperative. That will require another Buffett-style trade: Swap much of the prized but value-detracting ‘comfort’ for the much avoided but value-enhancing ‘courage’.