Lupoff Friends and Family Interests

Investment Process, Idea Generation and Human Biases

Narcissus does not fall in love with his reflection because it is beautiful, but because it is his - W.H. Auden

We've had many conversations with investors of late, about idea generation, process and why culture matters. It is our view that these three concepts are inextricably tied together if you are to succeed as an investment manager. We routinely make the point that many large and well-known investment managers may appear to be seamless engines, but their "franchise" masks the dysfunctional ways that ideas are identified, processed, find their way into portfolio and cause compensation to investment professionals. Accepting that any manager may argue that their particular methodology is proprietary and distinctive (ours is *BRACE*)[1], then I would maintain that it is firm culture and sensitivity to human biases that can be the difference between mediocrity and out-performance. Put less dramatically, *given a manager's plausibly effective process, it is culture and the wringing out of human biases that allows a manager to demonstrate the differentiation of their methodology*.

Culture and Drinking the Kool-Aid

Culture often evolves from day-to-day behaviors in an investment firm, with little forethought by founders/principals about what kind of place they want to work in, create and be known for. I care about this and have given a lot of thought to the lasting legacy that I hope is *Tiburon Capital Management.* However, in money management, to my thinking, culture is first and foremost about fostering an environment that will yield the best risk-adjusted investment decisions for the firm's investors.

If you were to ask any CEO of an investment firm about the ideal culture, I am sure that all discussions would include: high energy, professionalism, and healthy internal competition. Some more enlightened might talk of harnessing the skills of the many throughout their diverse organization. These platitudes are great, but frankly it is much simpler (on paper) than all this (assuming you don't suck):

1. Get buy-in to firm culture, mandate and process; and
2. Wire compensation into effective output (research product) and performance adequately and fairly.

Biases Driving Rot From the Bottom and Rot From the Top

Research, themes and the portfolio allocation decisions that are the consequence, are the investment firm's form of *innovation*. Idea generation in investing, as with any corporate product innovation, can fall prone to *Not Invented Here* and *Proudly Found Elsewhere* biases. This is seemingly never discussed with clients. Let's define and discuss these biases.

NIH Bias

The *Not Invented Here ("NIH")* bias is a human social phenomenon that describes the unwillingness to adopt an idea or a product because of its origin. In this context, already existing ideas, for our purposes, investment ideas, are avoided/ignored by a persistent social, corporate or institutional culture. If those investment ideas (proposed or enacted by others outside the firm - buyside or sellside) were worthwhile, *we* (ourselves) would have already thought of them. Thus, if it is "not invented here", it is not worthwhile.

In general, one's own ideas are valued higher and are more appreciated than those of others. Accordingly, other sources than one's own are seen as hostile or inferior. This often leads to a dismissive and pejorative attitude towards other outsider-driven ideas.

[1] Call us to discuss *BRACE*. See this synopsis of *BRACE* on *Fox Business News* with Liz Claman: http://video.foxbusiness.com/v/3717506484001/bracing-your-portfolio-for-the-best-and-worst/#sp=show-clips

NIH bias in investment firms can occur for two reasons: 1) the firm has done a great job of winning the hearts and minds of personnel regarding culture, mandate and process and now has a team that is *Drinking the firm-served Kool-Aid*. The danger, of course, is more about missed opportunities - as there is an active decision to ignore ideas developed elsewhere; and/or (and more insidiously); 2) an individual within the professional investment team devalues the work of anyone else on the team. Effectively *the individual has an internal culture and firm* (ego, personality, ambition-driven) and their NIH bias manifests in valuing their personal work higher or to the exclusion of colleagues. NIH bias needs to be wrung out or subsumed to the greater good - best risk-adjusted investment decisions for the firm's investors. Tinkering here by thinking of the war fought in markets as *guerilla* in nature, rather than *regimental* helps. Such thinking can allow some impurity (outside ideas) to enter the otherwise pristine process. And if it's a problem with an individual (as in point 2 above) – they have to go.

Edison - An Historical Example

The danger of people become obsessively attached to their own ideas is that they fail to objectively evaluate ideas from other sources. Thomas Edison fell into this trap when he tried to dismiss and discredit alternating current ("AC") as a substitute for direct current ("DC") which he had invented. Ironically the inventor of AC, Nikola Tesla,[2] was working for Edison when he developed it. This meant Edison could have taken the patent (and credit) for AC. However, Edison was so protective of his own creation that he failed to see that only AC could provide the scale and scope needed for the extensive development and use of electricity in the modern age.

Your Aunt Sadie's Paintings – Why She Proudly Displays Her Awful Artwork

So, as *Auden* said about *Narcissus* in the quote at the start of this paper, he looked lovingly at his own image *because it was his*. This is at the root of the NIH bias, whether institutional (point 1 above) or individual (point 2 above). Let's focus on the individual. We are human. Regardless of buy-in of culture, mandate and process, the investment research conducted is accomplished by human beings with their biases and foibles. So why can't Aunt Sadie see how terrible her artwork is; how narcissistic it appears to rational people, that she displays her work in her home? Because it's *her* work!

The behavioral economist Dan Ariely[3] conducted experiments to understand why this occurs. His tests and studies suggested that:

- People appreciate their own ideas a lot more than those of others.
- When they have created something themselves, they become much more attached to it and can greatly overvalue the potential importance of the idea.
- We sometimes discover ideas ourselves that may have been invented elsewhere. If we adopt the idea we soon overvalue the usefulness of the idea as if we had invented it ourselves.
- NIH bias encourages a high level of commitment and determination to see our own ideas through to the end.

To recognize these biases in ourselves is the first step toward wringing out the risks and fallacies in our own logic about an investment idea or any work's value. The last point regarding commitment to seeing our own ideas through can explain why it is so hard to convince ourselves that we might overvalue an idea. It surely explains why it is so hard to convince others. Ariely's findings also support the logic behind the theoretical dispassion of a Portfolio Manager and/or committee/investment team in evaluating another individual's proposed investment ideas.

Finally, it also explains why it is so important to praise and compensate for work done well and recommendations and decisions rendered dispassionately, as the behavior is in conflict with our human

[2] Nikola Tesla invented AC. The story of Tesla and Edison is an unfortunate one that chronicles power play and hubris. Worth a look if you are unaware of their history or interpersonal dynamic.

[3] I strongly recommend *Predictably Irrational – the Hidden Forces that Shape our Decisions*. Dan Ariely. Harper Collins Publishers, 2008.

coding. More on this later.

PFE Bias

I refuse to join any club that would have me as a member – Groucho Marx

The Proudly Found Elsewhere ("PFE") bias (with regard to investment ideas)[4] signifies the fact that ideas and innovation outside the investment firm are considered more worthwhile than expertise and ideas generated by the firm's investment staff. This "rot" can occur from top down, so to speak, as it suggests that either managers or colleagues seemingly *prefer* sourcing ideas via the work of sellside or other buyside firms, and in so doing, tacitly devalue internally generated work.

PFE bias in investment firms can occur for two reasons: 1) the firm has done a poor job of achieving buy-in by staff regarding culture, mandate and process. This could occur if the culture, mandate and process aren't well articulated, explicit and served in a reasonably strong Kool-Aid laced cocktail. Further, it may be that the process, per se, doesn't hang together or make sense to the investment staff, and rings false. PFE bias may also arise due to 2) rot at the top, i.e., senior personnel and/or Portfolio Manager(s), other analysts actively devalue or discount the internally generated research while praising the work of others (from outside the firm). I have seen this (and all these dysfunctional behaviors discussed) in my career and this is usually ultimately about money. The senior personnel, once they have wooed and cultivated the investment team, beat on them, their work, their skills and ego in various ways in part, in order to early on establish the basis for their own disproportionate compensation at year-end. This could and should really be read by staff to say, "if you'd work here/*for me*, you must suck."

The Healthy Balance

So why is it so hard for investment professionals to consider and concede that meaningful ideas and themes could also be originated elsewhere? What stands in the way of this, typically, is ego. No analyst really wants to admit that they are reusing an idea from a colleague, sellside or a competitor. Institutionally we want to believe we have created something unique and distinctive. Individually, we want to believe we are the reason for our institutional uniqueness and distinctiveness.

As discussed, we all have a natural attachment to our own ideas - but the greatest missed opportunities might just come from those ideas that we dismiss simply *because* they aren't ours.

In most industries other than money management, there is a changing perspective on innovation. PFE in industries such as healthcare, consumer products and technology, is coming to mean taking the best ideas from one part of the world and helping migrate them to another. In some of these organizations, people may be specifically responsible for being definitively in charge of *finding things elsewhere* and articulating, disarming (diluting the angst about its source) and disseminating the best ideas across an organization. This could easily be a clearing house role for either the Chief Investment Officer or member of an investment team less tied to specific portfolio positions or research (if given human frailties, PFE inquiry is hard for a team to accept).

Alignment of Interests to Insure Ubiquity of Ideas

We eat our own cooking – Marty Whitman

A remaining important component to insure a sense of the ubiquity of good ideas, forming investment theses and positions that benefit clients, is the adequate and fair wiring in of compensation to derive effective output (research product).

[4] In consumer products and technology, PFE is less disparaging. In fact, current innovation studies suggest PFE is a preferred way to get to innovation beneficial to all, sooner. It is specifically in the investment field that it can be a derogatory and damaging to culture, though, as you read on, of course, we conclude that there is some happy middle ground between NIH and PFE.

Culture Sets the Table

So are investment personnel paid by the performance of *their* ideas in the portfolio or by the overall performance of the portfolio (consisting of the many ideas, generated by a team)? I have worked in places with both sorts of cultures. In the first instance, there is such direct payoff for individual ideas that highly dysfunctional outcomes are prevalent. Here are some observations of such firms:

1. Ideas in the fund often come from the boss/Portfolio Manager primarily, so that he/she can garner or argue for the majority of compensation.
2. Portfolio positions often come from the most eloquent, best liked, the closest friend of the PM, to the exclusion of those proffered by the less eloquent or meeker analysts.
3. Such a culture, like lawyers whose code of ethics requires them to zealously represent a client regardless of guilt or innocence, can drive analysts to put the best case forward on a trade idea, regardless of personal concerns, damaging data or risks uncovered by them. There can be a tacit *caveat emptor* – let the buyer beware – that exists between the Portfolio Manager and the analysts, and could translate into unforeseen risks for the client.
4. A portfolio could be conceived, then, that doesn't harness the full strength of an investment team, and is, in fact, skewed in ways that either may miss magnificent returns or introduce mammoth new risks.
5. Is it ego? Perhaps money is only one part, and pride of authorship and direct impact (NIH) drives the one-dimensional and zealous presentation of an investment idea. Such work might be done with career upside/organization downside in mind. That is, "if my ideas work, I can lay claim to them (for compensation)", for aggrandizement – "I want to be a PM, I want to start my own firm, and this will help." Or "If I am wrong, well, the Fund underperforms and I can hide behind the 'team' approach."

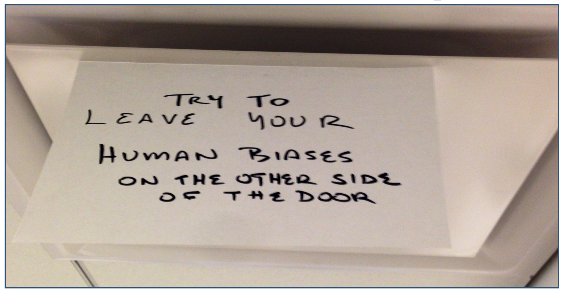
Our view at Tiburon is that investment professionals do not "own their names", i.e., the work done researching a prospective investment is "as a steward for the team and the firm's investors". Each analyst, then, is a fiduciary for their colleagues and clients. This reduces much of the potential dysfunction discussed above. If you are part of our team, it means you are valuable. At Tiburon, value is added by processing ideas but also actively (and civilly and professionally) participating in the discussions of other's ideas as well. Whether trade ideas ultimately wind up in the portfolio and how they perform does not drive compensation for any individual, but for the team.

So how best to reduce human biases and dysfunctional behaviors, to achieve robust idea generation and adherence to a proprietary process? There are no easy answers to this. The simplest palliatives are: personnel that clearly adopt the culture and shared vision, paying the team on portfolio performance, and active participation in the discussions of all work presented at portfolio meetings. *We eat our own cooking*, and this helps too: we make sure that not less than 20% of investment personnel's annual performance compensation is rolled in the Fund and tied up two years.

People/Culture: The Right People

So there is this fine balance that a properly operating team have some coherent, unifying process and objectives, but they need to be the kind of people that recognize their own human biases and do what they can internally, to keep them in check.

If It Matters to You, Make Sure People Know



Source: Sign hanging from ceiling in Tiburon trading room

The Drumbeat of the New

We do event-driven investing. What a terrific and exciting mandate! I tell you, there is always something to do regardless of markets, liquidity, cycles, etc. Like the shark, *Tiburon* in Spanish, our namesake – we do not stay still. Move or die. Put more poetically, there is *the drumbeat of the new*. A sound culture, mandate and process advanced by able investment professionals with buy-in makes the difference in being at the forefront of themes and proving differentiation in our *BRACE* Methodology.

Where the next big idea comes from should not be important. The risk-adjusted return of our investor's portfolio is. Flexibility to accept ideas generated internally or *Proudly Found Elsewhere* (and then reviewed via proprietary methodology and expressed in one's own institutional way) is the Healthy Balance called for in order to prove out a differentiated methodology.

Peter M. Lupoff **August, 2014** **Lupoff Friends and Family Interests, LLC**

Lupoff Friends and Family Interests, LLC
85 Broad Street – 17th Floor
New York, NY 10004
646.840.4925
www.lupoff.com