Thinking Outside the Box

“Fools find no pleasure in understanding but delight in airing their own opinions.”

~ Proverbs 18:2
A few years back I had the pleasure of meeting Emanuel Derman. A pioneer in the movement of physicists migrating to Wall Street, Derman was there when investors started using sophisticated mathematical models to make investment decisions. Derman has a Ph.D. in theoretical physics from Columbia University and had been a scientist at Bell Labs before moving on to a career in investing. We met at a lunch where he spoke about the difference between models in finance and models in physics.

As part of the talk he went through the history of thought in physics and the great thinkers who had changed people’s view of how the world works – people like Newton and Einstein. The one interesting thing I took away was that each individual that had furthered the science of physics had first spent an entire lifetime doing little but studying physics as it was understood before them. In other words, the true pioneers that really did think “outside the box,” as we are so fond of saying today, first dedicated their lives to learning more about the box itself than anyone else who had come before.

This revelation really hit me. It makes complete sense, but it is completely foreign to the world we live in today. Social media is about shouting your opinion and having it confirmed by like-minded friends, not about understanding. Unfortunately this phenomenon is not isolated to the lowest common denominator that often drives pop culture.

We have interns here at Iron Capital. Typically we will have one undergraduate and one grad student per semester. It is a very popular program because we actually let them see under the hood – they get to analyze investment opportunities using the models we have created. Most of our interns are very good, and we have hired more than one after their graduation, but occasionally we get one who does not get it. Once we had one who really enjoyed thinking outside the box. He decided that he could drastically improve the model we use to analyze the stocks of growth companies. Sales growth should be the only thing we look at because, he informed me, it was the only thing that really matters. Grow sales and everything else falls in place.

I then asked him whether he had heard of Webvan? Of course he was too young to remember the pioneer Internet-based grocery delivery. Webvan is a great example of a company that imploded because they grew sales too quickly. The service was fantastic. I remember within months after it came to Atlanta the vans would be in my neighborhood almost every evening delivering groceries to my neighbors. It cost no more than the regular grocery store, which ultimately was the problem. Webvan grew sales like crazy, and lost money on just about every delivery right up until the day it disappeared.

I explained to our intern something that his self-esteem generation ears were not used to hearing: more than 20 years of investing experience had gone into these models, and when he had been running these models for that long, then he could tweak them. In the meantime he needed to learn. I came from a generation in which this was made clear to me. I didn’t need my first boss to tell me that I didn’t know anything; I knew that I didn’t know anything. This intern wasn’t interested in understanding what went into our models, but he was interested in expressing his own opinion.

Seek first to understand. Stephen Covey, in his book “Seven Habits of Highly Effective People,” lists habit number five as seeking first to understand, then to be understood. Of course that bit of wisdom did not begin with him; it is as old as the
scriptures. I often tell my daughter that God gave her two ears but only one mouth, and she should learn to use them in the same proportion. (My son, on the other hand, I have to encourage to speak up, but that is a topic for another newsletter.) A thirst for understanding is helpful in every field I am sure, but it is crucial if one’s chosen profession is investment management.

Where does one go to obtain understanding? Many may think the university is a good place to start. I would suggest that this is certainly true in fields like dead languages, medieval Russian literature, or Egyptology; however, if one goes to school to learn about economics and finance, these are practical fields which can be practiced in real life. There was a time when I considered going back to school to get a Ph.D., and I was discussing this once with a hedge fund manager who had a PhD in mathematics. He asked me what I would study, and I said finance. “Why the hell would you do that?” was his response.

I was shocked, but he went on to say, “You can practice finance, you don’t need to study it in a university.” That made me think: Every really successful investor I knew of who had a Ph.D. had one in some field other than finance – most commonly in math, physics or psychology. Then I started thinking of other people I knew or knew of. My brother-in-law, a successful institutional bond trader for thirty years, has his MBA. I remember him telling me that he learned more the first six weeks of work than in the six years combined he spent in college and graduate school. Seth Klarman, the famous hedge fund manager, suggests the same thing in his book, “Margin of Safety.” Klarman has an undergraduate degree from Cornell and an MBA from Harvard, but says he learned more working for Max Heine and Michael Price at Mutual Shares (now part of Franklin Templeton).

Please do not misunderstand: I put a very high value on education. In fact, I believe in education for education’s sake. It is my opinion that an educated person will lead a more fulfilled life. I also recognize that there are many areas in life where the greatest minds probably are at the university. But when it comes to investment management, the old cliché holds true: those that can, do; those that can’t, teach.

Why is this important? Because most of what passes for financial education these days comes from higher education and is then filtered by Wall Street. Nowhere is this more prevalent than the cult of index investing. It stems from this idea that markets are “efficient.” I use quotation marks because what is meant by this is that markets are always correct, not that they operate in an efficient manner.

Of course this is complete nonsense. As C.S. Lewis liked to observe, this is an example of humankind’s propensity to be oblivious to the obvious. Oil cost more than $100 a barrel just a year ago and today costs $45. The actual supply and demand relationship has not really changed, so which is the correct price? If $100 was correct, why did it drop? If $45 is correct, why did it ever go to $100?

Even most academics have given up on the idea that markets are efficient all the time and recognize that at least occasionally market participants act irrationally. However they still won’t give up their holy grail of index investing. They continually cite studies showing that the average manager underperforms. This is a fact; average is not very good in my business. Of course my business is not alone, and this is a little bit like making the bold prediction that G students don’t get straight As.

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Iron Capital has been in business now for more than twelve years. One of our primary functions for both our institutional and individual clients is to pick investment managers, usually through mutual funds. We track how well we do this task every quarter. On average 81 percent of the managers we selected at least five years ago are better than average over the five year period. Over 59 percent of the managers we select end up in the top quartile over five years, and a whopping 73 percent beat their index. So much for that “can’t identify superior managers” theory.

Of course, we have had a slight advantage – for a decade, from 2000 to 2010, almost every active manager beat his benchmark. The index crowd never admitted defeat, they just got quiet. However, over the last few years the indexes have been winning. I’ve been doing this for a long time, and these trends certainly do occur. What I have noticed is that the index will tend to outperform active managers when something is not right in the market, usually in the last phase of a bubble.

The index crowd does not seem interested in understanding why the aggregate of professionally trained investors, who through various techniques and strategies pick investments that seem sound, might be underperforming the index. They just wish to shout their opinion. It seems to me that one might ask why?

If active investment managers are doing worse than a market index, that means the managers either do not own or own less of the stocks within the index that are seeing the highest growth in price. It would seem to me that if we go through a period where almost no professional investor wishes to invest in these companies, then one should question whether something is amiss. That certainly happened in the late 1990s when this craze first took flight, and it turns out that most managers not buying worthless dot-com companies were pretty smart. The next time the largest index, S&P 500, had a solid winning streak was right before the 2008 crash. It was happening again over the past year and guess what, we are now in a downturn.

This will not convince any of the true believers – not the academics who can’t do it themselves and therefore believe no one can, or the Wall Street product-pushers who make more money the more people trade. Most managers own fewer stocks than are in the index, which means fewer trades and less money for Wall Street. Of course better, in their view, than the mutual fund is the exchange traded fund (ETF). Wall Street makes money on each trade into and out of these funds, as well as all the buys and sells which are created when the ETF sponsor must increase or decrease its holdings.

Carl Icahn has warned that ETFs will be the next bomb to blow up in Wall Street’s face. Who is he but an old-time active investor who has not been doing so well relatively speaking over the last year or so? Perhaps I’m wrong – are we the fools who fail to understand but delight in our own opinions? I don’t think so, if for no other reason than the fact I often ask myself that very question.

There is no doubt that our approach at Iron Capital is currently considered out-of-the-box, but we have collectively studied that box for a long time. I think we have earned the right to step outside.

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