APPLIED RISK STRATEGY
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Humble Confidence and Creativity

The beginning of the year and break over the holidays provides a natural point for some deeper reflection about the year ahead. One of the most fruitful catalysts for thought that I have found is what is widely considered to be the greatest recorded collection of wisdom literature, King Solomon's book of Proverbs.

Here one absorbs the recurring theme of personal humility – perhaps the dominant theme – of Solomon's thoughts:

> When pride comes, then comes disgrace, but with humility comes wisdom (11:2).
>
> Pride goes before destruction, a haughty spirit before a fall (16:18).
>
> Before his downfall a man's heart is proud, but humility comes before honor (18:12).
>
> Do you see a man wise in his own eyes? There is more hope for a fool than for him (26:12).

The great thinker St. Augustine likewise notes that, "Humility is the foundation of all the other virtues; hence, in the soul which this virtue does not exist, there cannot be any other virtues except in mere appearance."

An Empirical Case for Humility

Within money management, these ideas seem to be borne out in anecdotal evidence, especially over the last twenty years with the episodic implosion of investors and investment firms favoring pride and arrogance over humility.

But I was fascinated to discover a recent study authored by Arman Eshraghi and Richard Taffler of the University of Edinburgh, entitled "Fund Manager Overconfidence and Investment Performance: Evidence from Mutual Funds."

In the research piece, the authors sought to take a more scientific approach to exploring how prior investment performance affects a manager's state of mind (particularly relating to overconfidence), and, how an apparently overconfident manager performs in subsequent periods.

The authors begin by identifying indicators of overconfidence (said differently, a lack of humility), including:

- **Self-serving attribution bias** – people attributing success to their own dispositions and skills, while attributing failure to external forces or bad luck

- **Self-centric bias** – individuals overestimating their contribution when taking part in an endeavor involving other participants

- **Prediction overconfidence** – the overestimation of the accuracy of one's predictions

- **Illusion of control** – belief that one has more influence than is the case over the outcome of a random or partially random event

The study begins by the creation of a comprehensive universe of US mutual funds over the 2003 to 2009 period. Beginning with the 5,371 funds with complete returns data for at least three years over the study period, this universe is then adjusted for funds that included no significant fund manager commentary in their annual reports, reducing the final universe to 4,659 funds.

The study authors then applied a novel approach to evaluating three proxies for overconfidence – overoptimism, excessive certainty and excessive self-reference – by using the Diction language analysis software application to review and characterize annual commentary written by each manager.

Here the Diction parameters were set to evaluate language indicating an overly positive perspective concerning opportunities or abilities, a resoluteness or inflexibility of view, and, most tellingly, excessive self-reference. The latter category was simply defined as the frequency of first-person singular and plural pronouns in each narrative (I, me, my, mine, we, us, our, ours).

The analysis then groups managers into three categories for each year – managers exhibiting indicators of overconfidence, managers exhibiting neither overconfidence nor trepidation ("normal" confidence) and managers exhibiting a degree of uncertainty and lack of conviction.

The authors draw several primary conclusions:

- There was a high degree of correlation between a manager's trailing performance and confidence level expressed in the annual report; those managers with the strongest past relative performance exhibited, in aggregate, the greatest degree of overconfidence

- A high degree of overconfidence, as defined and identified in this study, had statistically significant link to diminished future returns in the 12 months following publication of the annual report

- Managers exhibiting a degree of uncertainty and lack of conviction in their annual writings had typically just experienced a period of weak performance; their performance over the next twelve months also tended to lag the managers exhibiting "normal" confidence

The study concludes that a winning investment strategy – at least over the study period – would have been short the basket of overconfident managers, while being long the basket of those with more balanced levels of confidence.

Cockiness versus Conviction? Distinguishing Sources of Confidence

A certain investment manager that shall remain nameless graced the cover of Bloomberg Markets' most recent issue. One of anecdotes cited by the author was the subject's self-proclaimed NYT crossword prowess, where the manager claims to do Saturday's puzzle (the hardest of the week) in pen, while skipping Sunday's because it is too

easy. "You can do it, but what's the point?" the manager is quoted saying in the article.

In this almost cartoon-like example of apparent personal hubris, we have a reference point to consider the critical distinction concerning what object a money manager is placing his or her confidence in. **At one extreme, it would appear to be almost completely self-derived, often most firmly rooted in a view of superior personal intellect, skill, ability to predict future events or ability to compete.**

Such a perspective is of course at odds with the personal modesty suggested by humility, and leaves the manager self-dependent on outwitting the market and competitors. As a money manager, I am not sure how you sleep peacefully at night with this modus operandi.

The other end of the continuum of confidence-sourcing is an anchoring philosophy about how markets work and what factors are important to consider, a systematic and repeatable set of investment processes to express these beliefs and ideas, and a high degree of discipline and consistency in applying these processes over time.

This approach eschews prediction concerning how markets might move over shorter periods of time (in other words, 99% of all CNBC talking head content), **but expresses definitive view on the critical elements that do influence longer-term asset returns**, like valuation and implied investor expectations, deeper asset fundamentals, as well as the economic and political policy context silently shaping a country or region's future growth characteristics.

Creativity as an Outgrowth of Humility

To her great delight, our beloved ten-year old niece, Chase, received tickets for an upcoming Taylor Swift concert this Christmas. To my surprise, this led to a discussion later in the day about cognitive orientation, when Chase declared that she was a creatively-oriented right brain person, like her favorite musician.

We talked a bit more about what qualities those with the creative and expressive orientation might exhibit. In an attempt to provide some contrast, she delivered the verdict: "Uncle Ted, you are a left brain person. You do stocks."

While there will be plenty of time in future conversations to draw the distinction between "doing stocks" and the type of investing Lattice pursues should my niece ever care to know, I did feel compelled to make the case that **investing is perhaps one of the most fertile arenas for "righties" with a creative orientation.** This is best balanced, of course, with the co-existence of the analytical/logical "lefty" characteristics, either in the same individual or in surrounding team members.

A well-known principle that designers and artists frequently acknowledge is that creativity is amplified by constraints. In contrast to beginning a design exercise or artistic work with a blank canvas and theoretically unlimited options, the most innovative and original results often comes from the focus provided by limitations. Artists will often describe the liberation and freedom that fuels intense creativity once the borders of scope are defined.

In investing, humility – recognizing the illusion of short-term prediction and modesty regarding personal powers – is in many ways the most powerfully effective constraint. Freed from the need to demonstrate wizard-like predictions and short-term market calls to validate personal intellect, a manager can turn his or her attentions to the critical task of designing investment processes for that which can be known and controlled.

This approach requires inverting the investment industry's traditional focus on return to one of risk. A starting point here is coherent philosophy about how to assess risk. We need to look no further than the financial crisis five years ago to conclude that statistical artifacts like an asset's historical beta or volatility – which are, respectively, the orthodox risk measures employed in Modern Portfolio Theory and its handmaiden tool, mean-variance

optimization – fail to capture many far more critical elements of risk. These include valuation – an expression of embedded investor expectations – as well as a more penetrating understanding of an asset's fundamentals and the underlying risk factors that will influence its future risk and return characteristics. A comprehensive philosophy of risk also seeks to understand the conditional dynamics of risk as the backdrop evolves – how do assets respond during varying risk regimes (particularly the most turbulent periods), and across changing macroeconomic contexts?

With such a framework in place, tools and methods can then be developed to apply such understanding to portfolio decisions. These building blocks can be integrated and refined into investment process layers that are applied systematically over time, providing the basis for discipline and consistency in decision-making.

Systematic investment process layers can then be applied to different combinations of underlying assets, a palette that itself requires creative "risk design" to assemble.

Effective risk allocation – the primary driver of long-term portfolio returns – is at heart a design problem, best approached in a systematic manner. The most productive efforts here are likely to be those benefitting from the constraint of personal and predictive humility and the cultivation of humility's companion, expanded creativity.

Ted Lucas