BOOK
Investor's Paradox: The Power of Simplicity in a World of Overwhelming Choice

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SYNOPSIS [FROM THE COVER]
"Investors are in a jam. A troubled global economy, unpredictable markets, and a bewildering number of investment choices create a dangerous landscape for individual and institutional investors alike. To meet this challenge, most of us rely on a portfolio of fund managers to take risk on our behalves. Here, investment expert Brian Portnoy delivers a powerful framework for choosing the right ones – and avoiding the losers."

QUOTES
"No one grows up wanting to do fund manager research. Of all the lofty and interesting career aspirations that I recall from my youth and that I now see with my young children—fireman, astronaut, comic book illustrator, Pittsburgh Steeler, princess—the vocation of outsourcing investment discretion to professional money managers never figured. There are plenty of tales about young folks who developed an early passion for picking stocks. But this is something different. I suspect that no child has ever dreamed of doing the task to which I've devoted my career."

"By contrast, fund investors pick people, not securities. How to buy and sell people is a square peg in the round world of finance because people aren't tickers. They lack audited financial statements, and they don't vary in price from moment to moment (which isn't to say they're not volatile). People are riddled with behavioral biases, and they often don't act in ways that would be objectively considered rational. In finance, quantitative metrics might be open to interpretation, but they don't lie. People can and sometimes do."

"Few of us actually build our portfolios by directly selecting individual stocks, bonds, commodities, currencies, or other securities. Instead we turn to experts—to fund managers—to help us navigate complex markets."

"Attempting to pick funds that consistently outperform others is futile. Just as there's little evidence that even seasoned stock pickers can "beat the market," there is no evidence that fund pickers can regularly pick winners. While outperforming other well-informed talent scouts is unlikely, finding and selecting the right fund managers for a particular purpose is quite possible. This is accomplished by recognizing that out of the seemingly countless items that clutter investment decisions, there are actually just four core issues that should drive our quest for the right experts: Trust Risk Skill Fit."

"Prior to my markets career, I earned a PhD from the University of Chicago, where what I researched and taught was less relevant than how I was taught to pose questions and answer them. Endless information gathering without a method to structure it is akin to drinking from a fire hose: you are much more likely

to end up a sopping-wet mess than slake your thirst. In the world of investments, the fire hose of data is inexhaustible, which is why storytelling often passes for real insight."

"The availability of options ultimately becomes self-defeating. Barry Schwartz famously describes this "paradox of choice": When people have no choice, life is almost unbearable. As the number of available choices increases, as it has in our consumer culture, the autonomy, control, and liberation this variety brings are powerful and positive. But as the number of choices keeps growing, negative aspects of having a multitude of options begin to appear. As the number of choices grows further, the negatives escalate until we become overloaded. At this point, choice no longer liberates, but debilitates. It might even be said to tyrannize."

"Why does more often produce less? There are a few reasons. With lots of choices, we sometimes find ourselves overwhelmed, unable to process the information, let alone take action. The menu at the Cheesecake Factory or a traditional Greek diner at first amuses, but then overwhelms."

"It's what I call the investor's paradox: We crave abundant investment choices to meet daunting portfolio problems in a world of volatile markets, manic news flow, and shifting geopolitical rhythms. But the more choices we are afforded, the more overwhelmed, less empowered, and ultimately less successful investors we potentially become. More is less."

"Because complex times prompt us to seek complex solutions, investors have increasingly gravitated toward experts with extensive tool kits and flexible modes of thinking over those who are tightly constrained or who bet only that markets climb upwards over time. The deeper, more insidious level of our investor's paradox is that the more adaptable, creative experts are also the ones more likely to disappoint because we automatically expect more from them. In the theory of choice, unmet expectations trigger powerful emotions. When expectations and outcomes don't match, disappointment ensues. And because drawing clear expectations for flexible experts is much harder than it is for those with tighter constraints, the chance the former can satisfy is lower."

"Choice regimes evolve. We thus end up demanding variety we originally didn't know we needed (or didn't even know existed). And, even more interestingly, our own definition of the problem becomes more complex when we are presented with an increasingly differentiated series of solutions. A self-perpetuating feedback loop ensues."

"We tend to rely more heavily on experts to help us choose. We value experts precisely because they have the status of "expert."

"*Dow 36,000* was a best seller. Of course, Glassman and Hassett were egregiously wrong. Not long after the book was published, the DJIA peaked at 11,723 on January 14, 2000, and then fell sharply, bottoming on October 9, 2002, at 7,286. Stocks then surged again, and the DJIA peaked at 14,164 on October 9, 2007, only to swoon again to 6,547 on March 9, 2009. In September 2013, it hovers around 15,000. Fourteen years after their forecast, Glassman and Hassett aren't even close. After claiming in a 2009 interview that there was still hope ("Q: Do you still think it will hit 36,000? A: I have no doubt about that. I think that is absolutely true. But I'm not going to tell you what date."), Glassman finally admitted in a 2011 op-ed, again in the Wall Street Journal: "I was wrong."

"In our increasingly complex society, where the division of labor is sliced ever thinner, each individual's expertise is necessarily limited, rendering him reliant on others in most areas. He can therefore navigate the many choice regimes before him either by giving it his best shot—despite his lack of knowledge—or by relying on others for help. We're more likely to do the latter for more complicated decisions, where the resources (including time) necessary to choose wisely are significant, and when the costs of being wrong are high."

“One of the rarely noted features of choice in modernity is our frequent need to relinquish that choice to others who we feel could do a better job, or at least take the blame if things don’t work out as planned. Paradoxically, the more individual liberty we achieve—the more choices we have—the more we rely on the expertise of others.”

“This increased reliance on experts raises the potential for disappointment. That’s in part because we hold experts to a higher standard, as well we should: they should know better. A deliberately egregious example of failed expertise, Dow 36,000 certainly prompted people to buy more stocks on the expectation that this forecast was at least reasonable, if not precisely correct. In other words, the use of legitimate, credible experts—in finance, meteorology, medicine, sports, engineering, and so forth—establishes legitimate, credible expectations for what the future holds.”

“It is not accidental that our current era of overwhelming choice has produced so much public contemplation over how our decision making falls short and why, in turn, we seek expert advice. There is now a cottage industry in writing about experts, expertise, and forecasting. Serious books with titles like *Wrong, Being Wrong*, and *Why We Make Mistakes* now line our bookshelves. The popularity of Malcolm Gladwell’s *Blink* and Daniel Kahneman’s *Thinking, Fast and Slow* reflects enormous interest in behavioral quirks—and their consequences.”

“Tetlock’s marquee finding was that experts were not skilled in understanding what would come next in the fields to which they had dedicated their careers. Rather, Tetlock’s simple, even random decision rules were nearly as accurate as the informed experts. “It is impossible to find any domain in which humans clearly outperformed crude extrapolation algorithms, less still sophisticated statistical ones.”8 The lack of skill was evident across regions and categories, as well as whether the forecasts were short- or long-term in nature. Nor did experts significantly outperform nonexperts. “People who devoted years of arduous study to a topic were as hard-pressed as colleagues casually dropping in from other fields to affix realistic probabilities to possible futures.”

“Bernanke was hardly the only one who had relatively little grasp of the impending meltdown. In testifying to Congress on October 23, 2008, Bernanke’s predecessor, Alan Greenspan, attempted to evade most of the blame for the crisis but did haltingly admit: “This crisis has turned out to be much broader than anything I could have imagined.”

“Only 21.2 percent of fund of funds managers channel alpha from managers after subtracting fees. And only 5.6 percent of them add value above the alpha created by the underlying managers. In other words, only one out of twenty professional hedge fund pickers exhibits the skill we would expect them to have. Finally, there is no significant difference between the average fund of funds and a random fund picker.”

“Tetlock doesn’t pull punches: “We too easily convince ourselves that we knew all along what was going to happen when, in fact, we were clueless.”

“These are natural qualities that impede good decision making: Overconfidence Pattern seeking Risk aversion Information mismanagement.”

“There are few things we think we’re bad at, at least that we’re willing to admit to.”

“Professionals from astronomy to zoology rate themselves highly versus their peers. Cognitive researchers David Dunning and Justin Kruger not only demonstrate that we overestimate our own skill in tasks ranging from test-taking ability to motor skills to playing games; they also show that the least capable are most likely to overestimate their skill.25 These individuals are particularly weak at self-

assessment, tending not to take cues for self-improvement.26 It is only the truly skilled who tend to underestimate their acumen relative to others."

"Semiannually the Wall Street Journal asks fifty economists to predict the outcome on eight macroeconomic variables: GDP, the unemployment rate, the consumer price index, the three-month Treasury bill, the ten-year government note, federal funds, the yen, and the euro. Economists whose predictions were correct on extreme outcomes (i.e., those that deviated from the average by wide margins) were the most likely to be the worst forecasters in general."

"Like Babe Ruth pointing toward one spot on the distant fence, a bold call sets you up to be either hero or goat, but not much in between."

"One of the core arguments of Daniel Kahneman's Thinking, Fast and Slow is that the more active part of our brain is always seeking and often finding order, even when it doesn't exist."

"Studies of the hot hand evidence the Gambler's Fallacy."

"We Incur More Pain from Losing Than Pleasure from Winning. One of the more fascinating human biases is that losses tend to weigh more heavily on our psyche than gains do. Known as "loss aversion," this particular bias is highly germane to investing. "

"This topic is a deep well in the cognitive sciences, so let me point to three well-documented biases on how our brains work: availability bias, confirmation bias, and hindsight bias."

"When I read of a shark attack off the coast of Florida, I'm less likely to vacation there for fear of attack. But in 2012 there were twenty-six shark attacks in Florida, none of which were fatal, while injury and death due to rip currents were far more prevalent."

"Confirmation bias. We don't like to be wrong. It is personally upsetting and professionally dangerous. To say that we seek out evidence to confirm our beliefs and expectations is hardly new. The English philosopher Francis Bacon wrote in 1620: The human understanding when it has once adopted an opinion (either as being the received opinion or as being agreeable to itself) draws all things else to support and agree with it. And though there be a greater number and weight of instances to be found on the other side, yet these it either neglects and despises, or else by some distinction sets aside and rejects; in order that by this great and pernicious predetermination the authority of its former conclusions may remain inviolate. . . . The human understanding is moved by those things most which strike and enter the mind simultaneously and suddenly, and so fill the imagination; and then it feigns and supposes all other things to be somehow, though it cannot see how, similar to those few things by which it is surrounded."

"In the manager due diligence I have personally witnessed, the most common questions posed to managers are: "What's your best idea?" and "What's your edge?" These are leading questions, teeing up the portfolio manager to tell us how talented he is. My failure on Clifford Street stemmed in part from this. Inquiries into weaknesses or mistakes are rarely pursued with comparable vigor. Furthermore, studies show that confirmation bias is most pronounced when information is gathered sequentially (as in an unstructured interview) rather than simultaneously (as in a survey). So once we head down the path of "best ideas" and "edge," we tend to ask confirmatory follow-up questions."

"Hindsight bias powerfully influences how we evaluate expert decision makers. We believe experts should know better—that's why we employ them in the first place."

"We are overconfident. We see patterns where they don't exist. We focus more on the negative than the positive. We mismanage information in numerous ways. Yet, somehow, we still get by. We figure things

out.42 There are several factors that elevate the art and science of choosing, factors that directly inform all of the substantive chapters on investing to come. These are: Adaptation Feedback Satisficing."

"The method by which different experts evaluated information made a statistically significant difference in the quality of forecasts. Those with a more flexible, adaptive, and humble approach performed better than those using more rigid, overarching worldviews."

"Berlin resuscitated a line from the ancient Greek poet Archilochus, who wrote: The fox knows many things but the hedgehog knows one big thing. Foxes are cunning hunters, using many different tactics to survive. Hedgehogs are small creatures with limited tactics; under threat, they roll up into a ball. In the wild, foxes prey on hedgehogs. Berlin wrote in The Hedgehog and the Fox that the distinction between the two creatures "can be made to yield the deepest differences which divide writers and thinkers, and, it may be, human beings in general."

"The foxes of Berlin's and Tetlock's paradigm are flexible, self-critical, doubting. They admit mistakes. They embrace complexity. They think about their process of thinking, engaging in "meta-cognition." They endeavor to understand their own biases and mitigate their impacts."

"Tetlock's foxlike subjects were better forecasters in the statistically significant sense. "Good judges tend to be moderate foxes: eclectic thinkers who are tolerant of counterarguments, and prone to hedge their probabilistic bets and not stray too far from just-guessing and base-rate probabilities of events."

"Hedgehogs are often unwitting victims of unarticulated biases. They are more likely to be closed-minded and to exhibit hubris. They are averse to admitting mistakes, correcting them, and updating their beliefs. Not that the fox is the perfect hunter. Foxes are overly comfortable with, even solicitous of, complexity. On the surface, and perhaps at a deeper level, a fox's nimble mind lacks conviction. And sometimes foxes just make no sense. They've got too much going on."

"While foxes are more likely to be right, we generally prefer to listen to hedgehogs. We value pundits precisely because they tend to know one big thing. Right or wrong, we know where they're coming from, and we can judge them accordingly. Foxes can be tiresome, as well as wrong."

"In markets, there are foxes and there hedgehogs. More accurately, there is a spectrum of these qualities, and virtually all of us are hybrids of both."

"Traditional investors believe that markets appreciate over long stretches of time and that their portfolios should be positioned accordingly, meaning that they should always be bullish, or exclusively long the market. Regardless of their high intelligence and healthy skepticism, they have chosen to operate within constraints that mitigate the relevance of skeptical, adaptive thinking."

"Setting expectations for a fox is far more difficult than setting expectations for a hedgehog."

"A fox in the desert will be compelled to behave differently than a fox in the mountains. Likewise, not only is it important to consider whether an expert has foxlike qualities, but we must also understand the environment in which he operates, particularly the quality and pace of information flow."

"Why the variance? One proposition is that in some areas there is more opportunity to learn from past decisions. In turn, experts have the opportunity to make adjustments to new information. Take a domain that impacts each of us every day and for which experts have continuous feedback: the weather. Meteorologists know quickly whether they are right or wrong. As a result, the science of meteorology has been able to make significant strides over the decades, and professional weathermen are outstanding at predicting the future."

“Years of experience create a massive internal database to draw from, whereas for those in weak loops, a decade may not be long enough. My oldest son is ten, but whether I’m a skilled parent remains to be seen.”

“In sum, the difficulty of mastering one’s domain varies considerably according to both the inherent nature of the expert and the environment in which he operates.”

“In figure 2.1, I’ve made a simple graph showing this dynamic. The vertical axis reflects the spectrum from hedgehogs to foxes. The horizontal axis reflects the strength of the feedback loop. Domains in the northeast are conducive to positive choice outcomes. In areas where there is rich, fast-flowing information and where choosers (or those to whom we delegate) have adaptable, foxlike qualities, we are much more likely to be satisfied. The southwest corner is a sad place. Narrow-minded experts exist in a slow, thin information environment. It’s hard to imagine a lot of good outcomes under these circumstances.”
Reference Figure 2.1: Happy and Sad Decision Domains

“In his extensive analysis of the power and purpose of regret, Neal Roese writes that “the aching remorse of actions left undone, of better possibilities left unattained, is an emotion common to all people.”

“Roese points to an interesting study of the happiness of Olympic athletes that showed that silver medal winners tended to be less satisfied with their accomplishment than bronze medal winners. This is a somewhat counterintuitive finding insofar as second place is by definition a better outcome than third place. However, the yardstick by which either group measured itself drove the level of happiness. The silver medalists were disappointed at not being able to attain the top prize. But the bronze medalists were pleased to earn a medal at all. In other words, the former set their expectations upwards, while the latter set them downwards. Thus, an objectively better outcome produced less satisfaction.52 When outcomes don’t meet expectations, we are distressed in proportion to the magnitude and consequence of the miss. This is not merely a cold calculation; it’s a built-in physiological response.”

“A solution to expectations management is simple and intuitive: lower the bar. It is a common, long-held sentiment. Eighteenth-century poet Alexander Pope wrote, “Blessed is he who expects nothing, for he shall never be disappointed.” A standard assumption in classical economic theory is that all individuals are fully informed, rational decision makers who seek to maximize their utility. The truth is, while there’s something pure and aspirational about the constant quest to maximize, it’s also impractical. In the formal economic sense, this was first recognized by Herbert Simon, a prolific social scientist of the postwar era and an eventual Nobel Prize winner, who pointed out that humans lack the cognitive ability to engage in truly maximizing behavior.”

“This perspective, which has come to be known as “bounded rationality,” underlies Simon’s concept of “satisficing,” which suggests that we will choose less-than-best options owing to inescapable cognitive constraints. The notion of satisficing gives credence to the practice of focusing on the optimal, versus the maximum.57 Sometimes available low-cost solutions are good enough.”

“Any of us could come up with dozens of these examples from our daily lives. Ultimately, it’s not just a matter of what’s best, but of what works. We’d rather be approximately right instead of precisely wrong. This is satisficing.”

“Successful investing depends on building reasonable expectations of future outcomes and adapting those expectations in an informed, timely manner based on new information about our subjects as well as changes in our broader environment.”

“How we make choices depends on the context in which we choose. This context—what I have referred to as a choice regime—has a historical quality, meaning that what we focus on today is largely driven by what we considered and decided yesterday and the days and years before that.”

“The modern money management industry took off during the bull market in stocks and bonds that began in the early 1980s.”

“The Dow Jones Industrial Average closed 1964 at a value of 874; fifteen years later, at the end of 1979, the index sat at 838. It peaked in the early 1970s north of 1,000, but this fifteen-year stretch was hardly fruitful for most equity owners, especially those committed to investing “for the long run.”

“There is little academic disagreement over the occurrence of the Great Moderation, which lasted from roughly the mid-1980s to about 2007. Nor was this only a US phenomenon. Other wealthy economies, especially in Western Europe, also experienced similar patterns.”

“As in many other industries, an early mover advantage can be critically important for success. Indeed, seven of the top ten mutual fund firms (in terms of market share) in 1990 retained their top ten status by 2010.8 The “big three” fund complexes—Fidelity, Vanguard, and Capital Group (American Funds)—controlled nearly one-third of market share in 2010 but were also significant players decades ago.”

“Tiger was ultimately forced out of business by 2000 after the fund declined 19 percent in 1999, compared to a 21 percent gain in the S&P 500.19 Tiger stubbornly adhered to its sizable short positions on wildly overvalued technology stocks, only to watch those issues skyrocket further. The fund underperformed the market by 40 percent and saw the bulk of its client base demand its money back.”

“Granted, the golden era had episodic wobbles: the violent market crash of October 1987; the 1990 US savings-and-loan debacle; the 1994 Mexican peso crisis; the 1997 Asian crisis; and the 1998 Russian default. But in retrospect, in each of these instances, when risk premiums widened sharply, investors were handsomely rewarded for buying “on the dip.” Being greedy when others were fearful was the courage-soaked mantra of the time.”

“To start, it’s easier to define what hedge funds are not than what they are. First and foremost, hedge funds are not an asset class. According to Investopedia, an asset class is “a group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations.”21 By any stretch of the imagination, hedge funds do not fit this description—just as “mutual funds” are not an asset class. In either case, one is compelled to ask: What exactly does that particular vehicle invest in—and how?”

“Most hedge fund strategies tend to outperform in down markets, but underperform in up markets. The reason is not complicated: Most hedge funds hedge. Traditional investments do not, which is why they usually lose more money in bear markets. If risk is understood as the chance for permanent capital loss, then it must follow that many mutual funds take more risk than hedge funds do. And if this is true, it puts a premium on understanding how managers take risk, somewhat independent of the legal structure in which they operate.”

“Because of loss aversion, hedge fund returns can often feel better because, on average, the lows aren’t as low, even though the highs aren’t as high. Hedge funds’ likelihood of smaller drawdowns means less anguish in holding on to underperforming investments just in order to regain our high-water mark. The flip side is that, precisely because most hedge fund strategies don’t keep pace with the market during rallies, we experience feelings of regret.”

"Managing our expectations is perhaps the most difficult challenge of choice, but one way to do so is to look to those who have shown how constraints create their own beauty and freedom." —Sheena Iyengar

"Stories are the lifeblood of the human experience. We not only love stories, we need them to add meaning to our existence."

"We use stories to make sense of the world because our brains are not wired to think well statistically."

"In the world of money, it is people as much as events themselves that capture our fancy. There's no shortage of larger-than-life individuals— heroes and villains alike. Hero narratives are especially abundant driving the mystique of the hedge fund manager. In The Greatest Trade Ever, Gregory Zuckerman detailed the most lucrative investment of all time: John Paulson's massive short position in subprime mortgages in 2007, which personally earned him billions.4 The New York Times review of the book said it "reads like a thriller." Scott Patterson's The Quants is an expertly constructed narrative about traders such as Cliff Asness of AQR and Boaz Weinstein of Saba Capital, who employ highly sophisticated techniques to beat others and earn inexhaustible fortunes.5 Of course, villain narratives also abound—witness the number of recent books on Bernie Madoff."

"Our methodological goal is inference. How do we form reliable expectations when the future is inherently unknowable?"

"The line between the physical and emotional is quite blurry when it comes to the exercise of inference building. Expectations aren't just mind games; they are rooted in powerful biological forces. This sense of predictability and control is existentially satisfying."

"The "first law of manager due diligence" is that the less constrained a manager's mandate, the more difficult it is to set expectations."

"We have a Goldilocks problem on our hands. If we set expectations for something important—how a fund picks stocks, takes on leverage, works with counterparties, etc.—too narrowly, we will observe violations too frequently."

"Choosing to exit is hard. Selling something is often a more difficult choice than buying something. It's usually at the point of sale for any new purchase—a smartphone, car, board game, clothing, hedge fund, power saw, etc.—that we are most excited about the process of choice. At that moment, it's all possibility and promise. We've been convinced by others or ourselves (usually both) that the features and benefits overwhelm whatever potential drawbacks might exist. Then that moment is gone. And we have to live with our decision."

"Changing your mind is hard. It's even more so when it involves admitting a mistake."

"We grow emotionally attached to our possessions, including our investments. The principle of loss aversion aggravates matters, because once we're in a losing situation, we feel even more compelled to hold our losers until we get back up to scratch."

"When evaluating fund managers, the more challenging and fascinating task centers on our ability to reset our expectations in synchronicity with adaptable, foxlike experts. The more flexibility we afford them, the more we must engage in an iterative process of setting, managing, and resetting expectations."

"All experts have rules that guide them, but the truly innovative ones must depart at times from standard protocol; they must improvise. What are the rules for changing the rules?"

“There is virtually no way to have known Paulson would pull it off. There was little in his long career as an expert in trading around corporate events to suggest acumen in structured credit. To be sure, Paulson is a smart, nimble professional, just as Miles Davis was a talented, nimble musician. Each of their landmark achievements is, after the fact, no surprise. In the frame of his own vocation, each responded to many years of pent-up environmental tensions and a largely untapped opportunity to resolve them. Yet that doesn’t mean anyone could have anticipated the impact of the Big Short or could have guessed that the greatest jazz album of all time would have been recorded, without rehearsal, in only a few hours.”

“The source of success (failure) for many managers has been the ability (inability) to adapt over time.”

“Arbitrage is one of the classic notions in finance: that there are profits to be made by trading two or more securities simultaneously where there is an anomalous price relationship among them. In its purest form, arbitrage should yield riskless profits, but that seldom happens. The more commonplace usage of the term refers to the art of trading multiple securities whose value should either converge with or diverge from each other.”

“I believe there are four basic questions that structure investment due diligence. These are the topics on which we form expectations about the experts we hire and then adapt over time to changes in them, the world around us, and ourselves: Trust Risk Skill Fit The overriding goal of The Investor’s Paradox is to simplify complex investment choices. By focusing our inquiry on these areas, we can find simplicity in a world of overwhelming choice.”

“Most pragmatically, it’s because performance chasing doesn’t work. Like a sugar rush, great returns feel good for a while and then dissipate, as a manager can rarely consistently meet or exceed our performance expectations. Still, we want to be with a winner, so we gravitate toward those who have generated strong recent performance. Yet buying high and selling low is a losing strategy.”

“On the back of his emerging brokerage business, Madoff began to lure clients in order to manage their assets. Brokerage and asset management, though both “financial services,” are very different businesses. The former is a transaction-based service, facilitating the real-time buying and selling of securities; dealers aim to extract the small price difference between what a buyer bids and what a seller asks for. Asset managers serve as fiduciaries for their clients, who allocate their capital to experts who then attempt to earn a certain rate of return on those assets. Both are completely legitimate businesses. It’s just that combining them under one roof is fraught with potential conflicts of interest, insofar as what might be good for the broker at any one time is not necessarily good for the client.”

“Madoff leveraged the network of his father-in-law, Sol Alpern, a successful accountant. Alpern actively solicited capital from associates, sometimes promising that his son-in-law could deliver 20 percent year-in and year-out.6 Erin Arvedlund describes individuals such as Michael Engler, a Minnesota businessman and World War II veteran, who in turn steered others to invest in Madoff: “It was this high level of trust that led smart and savvy people—especially in the Jewish community—to invest with Madoff over the ensuing years without asking serious questions. And they were not driven by greed . . . but rather by the desire to invest in their futures with someone they felt they could trust.”

“The challenge is that everyone one step ahead of you on the food chain has an existential problem that you do not. For the investors, every party in front of them on the chain is a piece of a puzzle, one element of a larger portfolio. As such, predictability is a paramount concern, so much so (as we discuss in chapter 7) that skill per se is defined by the ability to deliver consistent risk exposures. But the intermediaries and managers are ultimately concerned about their own well-being and their ability to survive. As we will see in coming pages, it is periods of crisis that exacerbate this mismatch. Thus, we are solving an optimization problem; they are solving an existential problem.”

"If I'd had more time, I'd have written a shorter letter." —Mark Twain

"Cartographers don't make life-size maps for a reason. Likewise, inquisitive fund investors don't transcribe every detail of what a manager does. There's a difference between being comprehensive and providing perspective. The goal of manager due diligence is to understand the relevant features of an investment. We're aiming to set expectations and then adapt those expectations in a dynamic market context."

"This isn't easy. Portfolio managers and those who research them tend to get mired in endless detail, to lose the proverbial forest for the trees. The challenge is to transform the deluge of data into useful information, to separate signal from noise. Or according to Einstein's first law of work: "Out of clutter, find simplicity."