Chapter Eleven: *Failing Conventionally*

by Nathan Polackwich

Professional investing is a pain in the amygdala. Clients have a right to demand solid long-term results. But many also unreasonably expect short-term performance to always be favorable, which, though impossible, affects how professionals manage money. Professional investors must also confront pressures of conformity from their investment committees and firm management. Given that professional investors account for the vast majority of trading in financial markets, these pressures undoubtedly hurt the stock market's diversity.

The short-term performance and conformity pressures faced by professional investors were probably best described more than 70 years ago by one of the greatest economists of the 20th century and a legendary investor in his own right, John Maynard Keynes, in his treatise, *The General Theory of Employment, Interest, and Money* (1936):

> Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces that he himself finds the prettiest, but those that he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view.
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> …If the reader interjects that there must surely be large profits to be gained from the other players in the long run by a skilled individual who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame, he must be answered, first of all, that there are, indeed, such serious minded individuals and that it makes a vast difference to an investment market whether or not they predominate in their influence over the game players. But we must also add that there are several factors that jeopardize the predominance of such individuals in modern investment markets.

Investments based on genuine long-term expectation is so difficult today as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes…It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough – human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate…Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money…Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional, and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy.

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Keynes' point is that most investors, and particularly professionals, often judge an investment not on its long-run fundamentals, but on how they think other investors will perceive it in the near-term. Consider, for instance, the professional investor who thinks a recession might occur within the next 12 months. Because he fears the reaction of other investors to such an event, he would feel pressure to avoid companies with businesses highly sensitive to economic growth – *even if he thought the stocks were currently cheap based on their long-run merits*.

Why are professional investors subject to such myopia? Because their results are judged at least monthly by clients and *daily* by their firm's management. Unfortunately, being right in the long-run means little if your clients have all left and a pink-slip arrives before your judgment can be vindicated. Thus, Keynes observes that, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

Keynes was, however, a rare example of a successful practitioner of the "beauty contest" approach to investing. Maybe he was just lucky, or perhaps he had a unique ability to divine the future direction of the stock market's emotions (though he was nearly wiped out in the 1929 crash). Whatever the reason, Keynes was highly unusual among history's best investors who tend to personify his description of "the skilled individual, who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame."

The pressures faced by professional investors provide two possibilities to score points in the Winner's Game. First, short-term performance pressures create long term opportunities.[1] Say professional investors are shying away from drug stocks because they believe a Democrat will be elected President next November. It doesn't matter that the Democratic nominee's healthcare plan won't significantly impact drug companies' profits. All that's important is that professional investors fear that when the election results are tallied, if the Democrat wins, other investors will sell drug stocks indiscriminately. That may well happen, but the lack of buying interest in drug stocks because of a short-term issue like a Presidential election may create a long-term chance to earn exceptional returns.

The second opportunity comes from the pressure on professional investors to conform their opinions to that of their investment committees and firm management. Famed investor Jeremy Grantham refers to this pressure as "career risk." If the professional investor chooses to follow everyone else off a cliff, he probably won't be singled out and fired. However, if he goes against the grain *and is wrong* he will most definitely be fired. For many professional investors, the decision to conform is obvious.

The pressure to conform often causes professional investors to coalesce around an investment area or strategy *after* it has experienced a period of prolonged success. These investments are then deemed "prudent," a characterization that should cause investors to shudder and widows to hide their pocketbooks. Peter Lynch once remarked that "historically, stocks are embraced as

[1] Bill Miller calls this "time arbitrage."

investments and dismissed as a gamble in routine and circular fashion, and usually at the wrong times. Stocks are most likely to be accepted as prudent at the moment they're not." The same can be said about the stocks of companies in particular industries and even other asset classes (junk bonds, commodities, hedge funds, etc.). In the late 1990s, for instance, most professional investors considered technology stocks prudent investments. Didn't you hear? The Internet changed everything! Today, professional investors consider investments in emerging markets and commodities as eminently prudent. I know. I know…China's going to take over the world, and we're running out of oil.