Where are the philosophers?

Why we should be arguing with ourselves

There are truths in the investment world, as well as fallacies. Jack Gray believes the industry should be discussing them more vigorously, and that experts should be more ready to question their expertise.

In the hills of Greece, around 200 BC, there flourished a school of philosophers known as peripatetics, whose singular view, one to which Plato was sympathetic, was that the physical, social and political worlds (and by extension, the economic and financial worlds) were totally static, that nothing ever had, ever would or ever could change. To them all, supposed change was mere illusion. In the privacy of my boudoir, I've been speculating on what the peripatetics would say had they been witness to the financial markets and the financial services industry over the recent past.

Could they dismiss as mere illusion the collapse of Asia and currencies, the gravity-defying US stockmarket, the manifold derivative disasters, M&As of breathtaking size and scope, globalisation, retailisation, new asset sectors and a fast-flowing stream of ever more regulations and legislation? Wouldn't the peripetatic view be totally indefensible? I suspect not. They could argue that on deeper investigation these changes would be exposed as superficial and transient, like the shadows emanating from the Platonic cave. They could argue that the essential nature, structures, processes, features, benefits, risks and decision-making of investments have persisted and have at most changed merely at the margins.

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- strategic asset allocations and investment strategies in general;
- models, such as optimisers and asset/liability models;
- theories of capital-market behaviour and asset pricing;
- understanding of and management of the multifarious nature of risk;
- investment processes and products;
- investible asset sectors (commodity futures etc being marginal);

and that the perceived changes such as passive management and style analysis have not affected our structures, models, decision-making, behaviour or results in a substantive way.

I have some sympathy for any neo-peripatetics; at some levels there has been little substantive change.
The purpose of this conference is to revisit issues surrounding the development and management of investment strategies with a critical openness and in an environment of healthy debate, to see if anything has changed, or should change.

On joining this industry I was struck by the lack of genuine, open and critical debate compared to that I had experienced in academia, where collegiate abuse was the norm. This lack of open debate has serious and potentially dangerous consequences. Its main driver is the demand for commercial confidentiality that by the grace of Stiglitz’s paradox is eventually self-defeating.

In spite of that, we are caught in a prisoner’s dilemma where decisions are often dominated by the business risk of being different (a problem that, with fund choice, trustees too will have to deal with). Second-order effects that limit openness and critical debate include our strong need to conform and to be comfortable in the face of massive uncertainty, and finally a misunderstanding of the role of experts.

One result of this failure to engage in meaningful debate is evident in herding, a behavioural pattern of which all are guilty. The uniformity of pension funds’ investment strategies is evident in Australia, the UK and the US. The variety of liability profiles and other characteristics implies this uniformity must be far from being Pareto-optimal. Convergence of everything – decisions, investment strategies and performance – seems to be the norm, a form of asymptotic peripetatism that defies the second law of thermodynamics.

Of course, the landscape is not as bleak as that. Actual strategic asset allocations show some signs of variability, although few as radical as that of the Yale endowment fund, with a 60% strategic allocation to alternative assets. Endowments tend to have more radical strategic asset allocations and adopt more radical investment processes because they have fewer agents draining off added value.

There is also some variation in the management of the strategic asset allocation, ranging from not setting any strategic asset allocation at all for those who see the long term as nothing more than a succession of short terms, to imposing a tactical asset allocation overlay on the strategic allocation.

These exceptions notwithstanding, uniformity is the norm and is a predictable consequence of lack of debate.

A computer science friend claimed that UNIX and other early operating systems were superior to the later DOS because they were designed and built in the open environment of universities, where the culture promotes exchange and sharing of information. The early development of the Internet also occurred in open environments. Almost all theoretical advances in investments, such as MPT, CAPM, Black-Scholes, asset/liability models, optimisers and behavioural finance, have come from relatively open (although not necessarily academic) environments where the prevailing culture is cooperation but with a strong undercurrent of competition.

Our closed commercial environments, where the prevailing culture is competition but with a strong undercurrent of cooperation, may not be in the end-user’s best financial interests. Openness is critical because maximum value is extracted from the drivers of our industry, knowledge and information, only through interactive, sharing networks.

The current adversarial roles create friction, duplication, similarity, conformity and noise. The adversarial roles and strong commercial imperatives mean that neither investment managers nor trustees criticise and challenge each other enough. Perhaps new “co-operative” but commercial structures, organisations and models of behaviour are needed. One consequence might be more power to clients and fewer investment managers and consultants, but with the few who survive being recognisably distinct.

The Q-Group and the Securities Institute of Australia are two of the few organisations that provide a co-operative environment through vehicles like this seminar. For that we should thank and support them.

The lack of genuine, hard, critical, open debate can have far more
dangerous consequences than mere suboptimal behaviour. Maxwell shows the importance of challenging authoritarians. Orange County shows the importance of challenging those who are experts. Metallgesellschaft shows the importance of challenging those who are experts. It may be that the most effective form of risk management is open, vigorous, critical, informed debate. Interestingly, regulations such as the sole-purpose test provide a platform for legitimising challenges.

At the technical/quant level (see Figure 1), where truth is static, certain, hard, explicit and convergent, limited debate does occur and is an effective means of correcting evident, objective mistakes. Some I've seen include:

- a portfolio manager arguing that a succession of heads in the throw of an unbiased coin increases the likelihood of a following tail;
- an analyst claiming that because a time series seemed to contain a trend it couldn't be random, misunderstanding that the essence of randomness is that all patterns appear (with the right frequency);
- a consultant using an A/L model to recommend a 1% change to a strategic asset allocation, when the input data measurement error was 5%;
- a fund manager misusing Brinson's paper (that 80% of the difference between returns is due to strategic asset allocation) to conclude that 80% of an individual return is due to strategic asset allocation;
- a corporate treasurer believing his risk models had eliminated all risk from his portfolios in spite of the fact that according to one study, over the past decade 20% of the $24 billion worth of derivative losses have been due to model risk.

But debate, discussion and challenge are even more crucial as forms of risk management at the non-technical, non-quantifiable, more judgmental end of decision-making (see Figure 1), because here the nature of truth is more akin to historical than to mathematical truth, where the most effective technique for unravelling truth may be a legal-like process of interrogation. This type of truth is evolving, dynamic, uncertain, soft, implicit and divergent. It is the sort of truth novelists, poets and painters are skilled at identifying, particularly truths about people, organisations and their interactions. As an industry we need to reduce our insularity by looking beyond narrow technocratic experts.

In this relatively non-quantifiable world where open, critical debate is a powerful weapon, the positioning of technocratic experts as omniscient gurus needs to change. This is not an attack on experts, but simply the observation that we don't know what reasonably to expect from them. For instance, the diffuse, complex and uncertain nature of truth about the markets explains why successful experts in our industry "get it right" only about 55% of the time. At those levels one wonders, for example, about the role of forecasting (some academic papers

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**Figure 2: Hypothetical forecasting**

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<tr>
<th>Accuracy</th>
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<tr>
<td>0</td>
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<td>Forecasting Horizon</td>
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JASSA Summer 1998
suggest it, particularly macroeconomic forecasting, died in the early 1970s. As a mathematician, I use the search for optima as a framework, which leads me to two questions. Does forecasting/investing accuracy as a function of forecasting/investing horizon look like Figure 2, with a maximum somewhere?

What does forecasting/investing accuracy as a function of the expected impact of events look like for different forecasters/investors? Are some forecasters/investors capable of picking enough of the “2σ” events to add value; are others capable of adding value only through marginal incrementalism? Can we distinguish between them?

Experts can and must be criticised by experts and novices alike, for without open criticism they might believe their own PR, become brittle and crumble like the eponymous character in Percy Bysshe Shelley's poem:

"My name is Ozymandias, king of kings:
Look on my works, ye Mighty, and despair!
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away."

Alan Greenspan, our present king of kings, will crumble in an instant when he gets a call badly wrong.

Experts are human. Behavioural finance teaches us that they are overconfident and vulnerable to making cognitive errors and following fashions. But without experts we have mere uninformed opinion. Experts provide critical, flexible, knowledge-based frameworks, they provide us with insight and wisdom, but they do not offer us the omniscience we crave.

As experts we seek comfort in the known. But is it not more important to reveal ignorance than knowledge? Should we not be ignorance managers as much as knowledge managers? In that spirit let me end with a few of our industry’s shibboleths, with some of the issues of which we are ignorant, issues that need to be debated so the complex, uncertain nature of truth can evolve.

- Equities provide greater long-term returns but as Peter Bernstein has observed, the cult of equities is only 50 years old.
- Diversification is an intrinsically good and effective method of risk management. But the risk of "diversification" is real and some hold the view that you should keep all your eggs in one basket but watch the basket very carefully.
- Derivatives are intrinsically dangerous.
- Active management cannot add value consistently because large liquid markets are efficient. But neither efficiency nor inefficiency persists; they are in dynamic equilibrium so one should maintain options for both active and passive. But how and to what extent? (See Figure 3.)
- Soros is a genius, but watch his PR machine and don’t be seduced by his intellect.
- Governance adds value.
- Groups can’t make effective investment decisions. Superannuation funds should overweight Australian equities both because our liabilities are here and to help develop Australia; but should we not have an MSCI weight of 2% exposure to Australia?

The more open and critical we are today, the more we’ll gain. My job is to help us climb the learning curve by encouraging you, the audience, to question and you, the speakers, to stimulate, provoke and admit to ignorance.

NOTES

1 Curiously, both Harry Markowitz and Bill Sharpe worked at the Rand Corporation which at the time was largely funded by the military, the most secretive and closed of all organisations. War and investing bear substantial commonalities: low signal-to-noise ratios, uncertain and dynamic environments, important distinctions between tactics and strategy, the need for quick decision-making and life and death consequences.

2 Will future generations find our perceptions of economic/financial truth as amusing as we find the perceived truths about physics held in the Middle Ages, many of which persist in the intuitions of novices? I wonder whether our deep but false intuitions about probability extend to deep but false intuitions about money and investments.

Figure 3: Active versus passive

![Figure 3: Active versus passive](image-url)