Salient

Theory in Action
Rusty Guinn

"A Man Must Have a Code"

Mallow: It lacks glamour?

Jael: It lacks mob emotion-appeal.

Mallow: Same thing.

- **Isaac Asimov, *Foundation***

It is the artist's function not to copy but to synthesize: to eliminate from that gross confusion of actuality which is his raw material whatever is accidental, idle, irrelevant, and select for perpetuation that only which is appropriate and immortal.

- **William Ernest Henley, *Views and Reviews: Essays in Appreciation***

Principal: Mr. Madison, what you've just said is one of the most insanely idiotic things I have ever heard. At no point in your rambling, incoherent response were you even close to anything that could be considered a rational thought. Everyone in this room is now dumber for having listened to it. I award you no points, and may God have mercy on your soul.

Billy Madison: Okay, a simple "wrong" would have done just fine.

- ***Billy Madison* (1995)**

Homer Simpson as Max Power: Kids, there's three ways to do things: the right way, the wrong way, and the Max Power way!

Bart Simpson: Isn't that the wrong way?

Homer Simpson as Max Power: Yeah, but faster!

- ***The Simpsons*, Season 10, Episode 13, "Homer to the Max"**

Bunk Moreland: So, you're my eyeball witness, huh? So, why'd you step up on this?

Omar: Bird triflin', basically. Kill an everyday workin' man and all. I mean, I do some dirt, too, but I ain't never put my gun on nobody that wasn't in the game.

Bunk: A man must have a code.

Omar: Oh, no doubt.

- ***The Wire*, Season 1, Episode 7**

What is your code?

A few years back I worked at the Teacher Retirement System of Texas. I was responsible for hiring ostensibly sophisticated money managers — hedge funds and others generally regarded as some of the most intelligent people our society has to offer. But the most impressive people I worked with were not London-based portfolio managers but two of my fellow laborers. At a public pension plan in Austin. Go figure.

The first, Dale West, is still probably the most intelligent person I've ever worked with, and with my current partners Jeremy Radcliffe and Ben Hunt would round out my fantasy Bar Trivia team, a list that unsurprisingly overlaps with my do-not-play-poker-with list. (No, in all seriousness, never play poker with Ben Hunt or Jeremy Radcliffe.) A former rising star in the Foreign Service posted in Bucharest, I'm pretty sure Dale was largely responsible for fomenting the overthrow of Ceaușescu, but he maintains that the most exciting thing he did was wire a report back to Washington about the grand opening of the first McDonald's in Romania. He might also say he was still an undergraduate in Austin at the time. Likely story.

I also had the pleasure of working directly for Chief Investment Officer Britt Harris, one of the wisest men and investors I have known. Britt is a native of the Rio Grande Valley of South Texas, and, like Ben and me he takes peculiar pleasure in the "I'm just a country boy" hustle familiar to all accomplished southern gentlemen. As an investor-cum-philosopher-cum-preacher, Britt was and is famous for imparting that wisdom in particularly pithy turns of phrase — Britticisms, if you will. One such Britticism was the idea that any person who wants to be consistently successful as a human being, and especially as an investor, must have a World View.

In this sense, having a World View means having a center — a core set of philosophies about how the world works, what is objectively true and false, and what actually matters. More importantly, it means internalizing these philosophies so that they are second nature — and so that they become a natural lens through which we judge the world, and which we can describe succinctly to those who ask. It means having a confident view concerning how we come to any measure of knowledge about investing and markets.

To those who have studied philosophy, yes, I'm basically describing an epistemology for markets. But out of respect for the hustle, let's call it a Code.

Unlike in abstract philosophy, however, developing a complete, fundamental view of the basis of our knowledge about markets is actually not a particularly good use of time and effort. Rationalists might argue for building thorough foundational theories on the underpinnings of human behavior, the resultant evolution of economic and financial systems and how those interact to create trillions of discrete price discovery events. Empiricists might argue instead for an ex-post analysis of price response to various identified factors or stimuli in order to develop a forward-looking framework for similar responses to similar stimuli.

The problem with both approaches is two-fold: first, the forces and individuals that comprise financial markets are far too complex to think we can ever have complete knowledge about what drives them. Second, even when we can develop acceptable models, humans create massive error terms that we lump into the epsilon of our model, to be ignored and abstracted from. This, of course, is the genesis of *Epsilon Theory* as a framework for investors.

In the face of overwhelming complexity and the constant exogenous shock of human stupidity, what does it mean, then, to have a World View? What does it mean to have a Code? From my perspective, it means three things:

1. You have a clear set of investing heuristics that are, by and large, provably true (i.e., what risks will be taken, and why do you believe they will be compensated?)
2. You have a process for implementing those heuristics and for handling their exceptions (i.e., how do I take those compensated risks?)
3. You can absorb new facts into your framework without breaking it

The right way, the wrong way and the Wall Street way

The investment industry has embraced this notion of Codes to varying levels of success.

The best examples are natural, organic expressions of why an investment company was formed in the first place. Dimensional Fund Advisors (DFA), a Texas-based firm (sorry, California) we admire very much, came into existence as a commercial expression of the pioneering work on the value premium by Professors Gene Fama and Ken French. DFA doesn't claim to have every answer to every question, but they claim to have one or two very big, important answers that matter an awful lot. And they built a firm and a Code around it.

Some Codes are willed into being by visionaries. The most famous such example is probably Bridgewater Associates, which is famous for discussing the "timeless and universal" principles that they believe underpin both the economy and financial markets. Above even these market-oriented principles, Bridgewater leans upon the principles established by Ray Dalio over many years, now compiled into a 100+ page tome. Not everyone may agree with all of the principles, but it is hard not to admire their Code and especially their commitment to it.

One family office in Ohio we think highly of has so embraced the importance of the processes that put their Code into action that firm policy dictates a regular verbatim reading of these policies and procedures as a group — aloud!

Most of the industry is less inspiring. I've met with hundreds of hedge funds, private equity funds, equity, fixed income and credit managers over the last decade as an allocator. Unfortunately, this experience provides very little to dispel the popular conception of Wall Street as being populated by charlatans or, worse, salesmen. Unfortunately, an entire mythology has formed around the ability of due diligence or manager selection teams to pluck out the good fund managers from the bad through huge checklists, data requests and face-to-face meetings where you can "look them in the eye" to find out whether they're good or bad people and good or bad investors.

It's all nonsense.

The sad reality — or the happy reality, for road-weary due diligence professionals — is that 90% of evaluating a fund manager can be boiled down to a single question: "How and why do you make money?"

When you ask this question, a fund manager with a Code's eyes will light up. The one without will pause and give you a quizzical look. "What do you mean?" He was prepared to tell you about his investment philosophy. He was prepared to tell you about his investment process — he had the funnel graphic and everything! He was prepared to tell you which five names added the most to his P&L that quarter. He was prepared to tell you about the sector he moved from 2% to 4% overweight.

What he wasn't prepared to do is tell you why any of that matters.

Rather than adopting a Code, individual investors, financial advisors and investment firms alike tend to try to define themselves by either a formal stated philosophy or some informal self-applied label of the type of investor they are. Invariably these descriptions are banal and infinitely transferable to the point of irrelevance.

I die a little bit inside when a fund manager tells me that his investment philosophy is something to the effect of, "We believe that our rigorous bottom-up, fundamental analysis process coupled with prudent risk management will allow us to produce above average risk-adjusted returns." This kind of statement is the surest sign that a fund manager has absolutely no idea what he is doing that will actually make money, in addition to being a sign that he is probably spending half his day in committee meetings. That is, coincidentally, the only decision-making structure that could come up with such a ridiculously incoherent investment philosophy.

Slightly more frequent, the fund manager expresses his philosophy by communicating how he sees the world differently from everyone else by seeing it just like everyone else. "Wall Street is just focused on the next quarter — our philosophy is that we will win by having a longer-term perspective." I might consider this a lovely Code if every other equity fund manager in New York hadn't said the same thing to me earlier that week.

Often the response isn't an attempt at philosophy but a reference to the size of a research team (i.e., look at our cube farm of disaffected millennials pretending to work on a dividend discount model while they look for tech jobs!), as if there were some self-evident transfer coefficient between headcount and returns.

In perhaps the most common case, the investor eschews the more formal philosophy statements in favor of the simply applied label, such as, "I'm a value investor." This, of course, is another way to say that you like to buy things you think are cheap because you expect them to be more expensive later. In other words, you are an investor. Congratulations, your certificate is in the mail, and meetings are every other Thursday at the VFW hall. The number of fund managers who think this is an adequate description of how they generate returns, perhaps self-lauding their own simplicity in light of the perceived difference in the way everyone else sees the world, is absolutely staggering.

What does a code look like?

And yet the problem with these isn't that they are bad philosophies. Okay, that's part of the problem. But the *real* problem is that even if they were *good*, they wouldn't be *useful*. And they aren't useful because they aren't measurable and because they don't provide any mechanism for decision-making. In our view, to be successful a Code should be explicit in highlighting four key beliefs:

1. The things that matter.
2. The things that don't matter.
3. The things that don't always matter, but which matter now.
4. The process and tools you'll use to focus on what matters and dispense with what does not.

It really is that simple. In future pieces, I will walk through my Code — our Code — in hopes that it will help to apply the principles of Epsilon Theory. And I promise — no funnel charts.

Okay, maybe a few funnel charts.

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