TRENDS & TAIL RISKS

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Clients Deserve More Than "Conventional Failure"

By LEWIS JOHNSON - Co-Chief Investment Officer | December 27, 2017

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."
- John Maynard Keynes

"It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat."
- Theodore Roosevelt

"From the sublime to the ridiculous is but a single step."
- Napoleon

"Ich kann nicht anders." (I cannot do otherwise.)"
- Martin Luther when ordered to recant the reforms of his "95 Theses" that created the Protestant Church in 1517

"Success is not final, failure is not fatal; it is the courage to continue that counts."
- Winston Churchill

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CHIEF CONCLUSION:

I can't tell you how many times in the investment business I have heard someone parrot to me the first quote, Keynes' famous line about how it's better to "fail conventionally" than to succeed unconventionally. If this sad view is truly as widely shared in the investment business as I fear it is, then it helps to explain why our firm is growing so quickly. I believe our entire careers have been characterized by a willingness to disregard convention, and to do what we believed was right for our clients. Isn't this the job that we were hired to do? The best way for us to achieve success is to make our clients successful.

The Fiduciary Model Promotes Better Outcomes for Clients Than the Broker Model

Many financial advisory firms make a big deal of the fact that they are fiduciaries. I believe that this is a better model for clients. Why? Fiduciary duty demands a higher duty of care for clients. In fact, fiduciaries are bound by the requirement to put their clients' interests first. Many licensed brokers, including many who work at such traditional companies as Merrill Lynch, Morgan Stanley, or Wells Fargo, have a lesser duty of care for clients because the investments that they recommend need only be "suitable" and appropriate. This can lead to a greater number of conflicts of interest between the brokerage company and its clients and thus a worse outcome for clients. Little wonder that so many are abandoning this old, flawed model and choosing to work with fiduciary investment advisors, such as our firm.

All Fiduciaries are not Created Equal. How Far is Your Fiduciary Willing to go for You? Clients Deserve Better Than to Fail Conventionally

The best investors I have ever known have always dared to succeed unconventionally. It was with their courage and conviction in finding undervalued ideas off of the beaten path, that they made their clients more successful. But first these investors had to dare to truly serve their clients, whatever the cost that imposed on their career.

From this rare breed are numbered many of the investors that I know and admire. There is just something in them, some compulsion that cannot allow them to rest. They dutifully seek out controversial ideas, disregarding the risk that in doing so they may look stupid. You see, they were willing to put themselves at risk for the betterment of their clients.

As someone so afflicted I can assure you that this drive is both a blessing and a curse. Quite certainly it has made my career in investing much more difficult. It's demands never end, nor do the risks they impose upon the sufferer. Some of these

"The world is not respectable; it is mortal, tormented, confused, deluded forever; but it is shot through with beauty, with love, with glints of courage and laughter; and in these, the spirit blooms timidly, and struggles to the light amid the thorns."
- Santayana

"He that lies down with dogs, shall rise up with fleas."
- Benjamin Franklin

"The mass of men lead lives of quiet desperation. What is called resignation is confirmed desperation. From the desperate city you go into the desperate country, and have to console yourself with the bravery of minks and muskrats. A stereotyped but unconscious despair is concealed even under what are called the games and amusements of mankind..."
- Thoreau

"Courage is being scared to death...and saddling up anyway."
- John Wayne

Source: Gustav Dore's Illustration of the fallen angel's cast out of heaven for "Paradise Lost"

tortured souls in their anguish built great investment firms on the bedrock of this principle. I am starting to understand that they, like Martin Luther, could not do otherwise.

These pages have highlighted many of their names. But let me let you in on a secret I have learned in twenty years of investing: what made them great was not necessarily brilliant insight, but rather their fearlessness on behalf of their clients. It was their courage to do the right thing, no matter the penalty that it imposed upon their own lives and their own livelihood that made all the difference. Let me explain.

Source: http://wholelifebalance.com

Career Risk: Serpent in the Investing Paradise

Many outside of the business of investing may have never heard of the concept of career risk. I think it's the dirty little secret of the analytical community. It's not the sort of thing that people discuss in polite company. To fully understand the barrier career risk creates, a first step is to understand the journey that many professional investors travel.

My own journey began at Wharton, where in 1998 I was one of 750 students fortunate enough to earn admission into its MBA program. This accelerated my investing career immensely and was the driving factor in earning one of only three spots nationwide in Capital Research and Management's (the manager of $1.5 trillion in mutual fund and other client assets) summer internship program in equity research in 1999. The next year, I was one of five new equity analysts hired at T. Rowe Price from its nationwide MBA recruiting program.

I, and my fellow analysts and former classmates working at similar firms, had found a way to overcome staggering odds to land the positions that we did. Compensation was excellent and could grow exponentially. Understandably, many of my co-workers and Wharton classmates felt like they had sacrificed and triumphed. But there was a serpent in our paradise: career risk.

Career Risk: A Tax on Client Wealth Imposed by Their Advisors

We would not have been human if each of us did not have a little devil appear on our shoulder to seductively whisper: "Congratulations! You made it! You are now a member of an exclusive club. Membership has its privileges. Don't do anything stupid to rock the boat and you can enjoy a long and lush career." Within the industry, the term for this whispering voice is the threat of "career risk." Career risk is something you run as an investor when your insights have identified the right course of action for you to take for your clients, but the execution of that insight could threaten your career if you are wrong.

On one hand, you have the conviction of your work that suggests (but cannot guarantee) that you are right. On the other hand, should you stick your neck out and fail (no one knows the future after all), your membership in the club might be revoked, and you could be cast out of heaven.

With so much to lose, is it any wonder that so many professional investors cling with determination not to be cast out from paradise – or more particularly to avoid being cast out for their own mistakes? Many investors do the math and reach the conclusion that they just can't bring themselves to risk being too far outside the mainstream. Mediocrity is the result, but it's a profitable mediocrity for them. For the client, however, not so much.

I will never forget one discussion I had with a colleague. I was in the midst of an aggressive investment campaign in the steel industry. I strongly believed that my analysis had identified a compelling opportunity in this depressed industry, when approximately 40% of its capacity was in bankruptcy and trading at bargain prices. With my earnest encouragement my employer at the time had become the single largest shareholder in the industry with half of a billion dollars invested in it at cost. My colleague asked me "You own 10% of the U.S. steel industry. How can you sleep?" I answered "I have to do this because this is the best investment opportunity I have ever seen." I knew the risks I was running but could not do otherwise. The opportunity was just too exceptional.

This experience, and many others like it, are why I remain convinced that true investment excellence is something that will remain elusive to so many. The barrier is not intelligence or insight. Plenty of people have that. It's courage. Perhaps some would argue that a more precise definition would be blatant lack of self-regard.

The few that do find the courage are driven by an even stronger force: the conviction that clients deserve better. But frankly, even for these tormented souls, who put their own future at risk to serve their clients, success is by no means assured. No one knows the future, after all. They could easily be wrong and suffer the consequences. Career risk is real.

In Conclusion

The many necessary tools of investing: accounting, finance, strategy, psychology, the harsh lessons of experience, all of these and many more can be learned. I do not believe, however, that courage can be learned.

Investing is fraught with risk. Not just for clients whose savings must face an uncertain future, but for those investors who are charged with shepherding that capital. Some professional investors, having done the math, will decide that it's not worth the risk and will mail it in. Sadly, this will be true whether or not they are "fiduciaries." I am not aware of any law that can force someone to jeopardize his own well-being for others. It has to be an inner compulsion.

The arc of my entire career, and that of our analytical team, has been defined by a continual willingness to put ourselves at risk for the convictions that we hold. This unstoppable force helped us to be successful but it cursed us too, never to be content. There is no hiding from it.

At each step we have made the hard decisions and gone with our convictions, willfully embracing Keynes' great risk. Looking back on my career to date, I can recognize the driving inevitability that led me, with my partners, to found our firm together and to invest as we do for our clients. It was the only thing I could do.

Please understand that there is no guarantee that the honest risks we run for you will be successful. Our only promise to you is that we will keep trying, and if we fail, that we will have failed you honestly, not from our fear of jeopardizing our own success at your expense. It's important to me that you know that.

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