One of the Biggest Sources of Market Inefficiency

In the U.S., the standard distance between railroad train tracks is four feet, eight-and-a-half inches wide.

The reason for this distance is because that was the measurement used in England and the U.S. railroads were built by British expats.

The reason the British used this distance is because it was the same measurement used on the old tramways (used for wagons) which preceded the railroads and the people who built the first railroads were the same ones who worked on the tramways.

The wagons used on the tramways were built to these specifications so the wheels would fit the ruts that had been made over many years on England's old roads.

And supposedly the ruts had been made by old war chariots which were four feet, eight-and-a-half inches wide to account for the width of two horses.

I'm sure there are plenty of details missing from this story but the narrative here provides a nice illustration of the idea that people and organizations often do things a certain way simply because that's always the way they've been done.

I read this account in a book called Retirementality: Planning Your Life and Living Your Dreams...at Any Age You Want. Author Mitch Anthony was trying to prove the point that most people's views on retirement are outdated:

Traditional retirement was premised only on wants, and society assumed that all retirees wanted were lives of leisure. The New Retirementality is premised on balancing needs and wants. Traditional retirement was focused on vacation, whereas the New Retirementality is focused on balancing vocation and vacation.

The idea of people doing things a certain way because that's the way they've always been done resonates with my experience in the finance industry, as well.

Career risk is by far one of the largest inefficiencies in the markets people rarely talk about.

Finance pros love to blame mom and pop retail investors for making every irrational mistake in the book but professional investors are just as likely to make mistakes. It's typically just for different reasons such as overconfidence and, more importantly, career risk.

I'm sure many outside the world of finance assume money managers and institutional investors who control massive amounts of money perform rigorous cost-benefit analysis, use a weight-of-the-

evidence approach, and make decisions based on thoughtful investment criteria.

The truth is many professional investment managers make certain decisions in hopes of saving or keeping their jobs more than anything. Politics tends to trump wisdom when large amounts of money are at stake.

This is why there's a bias towards action by financial firms. It's why the sales and marketing departments or soundbites are often more important than the investment process. It's why asset allocators chase past performance and succumb to peer pressure when making portfolio changes. It's why the pros favor complex investment procedures over simple ones.

Career risk is why advisors try to look like they're doing something, *anything*, to prove their worth and justify their fees by making constant portfolio changes or taking unnecessary risks.

I was first introduced to career risk while working for a group of sell-side analysts during my senior year of college. This group was extremely smart, performed endless amounts of research on the companies and industries they covered, and created the most beautiful excel models and pro forma financial statements I've ever seen.

But when it came time to make a buy/sell/hold recommendation on the stocks they covered it turned out their relationships with corporate management was often the deciding factor. These analysts didn't want to anger the executives they met with on a regular basis for information, so there were few, if any, sell recommendations placed on these stocks (I'm guessing investment banking relationships with these companies had something to do with this as well).

I was pretty naive in my understanding of business at the time but I'm now well-aware of the fact that many decisions people make have more to do with self-preservation and poorly aligned incentive structures than anything.

I talk to nonprofit institutional investors all the time who admit they need to make a change to their philosophy, strategy, money managers, or consultant but can't pull the trigger because it's not the "safe" move. So they stick with the status quo in hopes that not rocking the boat will eventually solve all their problems.

It's mind-boggling to me how many funds and investment products that have no business ever seeing the light of day exist almost solely because of career risk, a good narrative, and a solid sales staff. I've been baffled throughout my career at some of the allocation decisions I've witnessed from institutional investors controlling hundreds of millions or even billions of dollars.

Obviously, not everyone in this business makes poor investment decisions to keep their job safe. There are firms, funds, and institutional investment programs who have figured out the right organizational framework to avoid these mistakes.

But I think career risk is one of the most overlooked causes of market inefficiency there is.

Further Reading:
My Time on the Sell Side