

## The Hardest Question in Portfolio Management

"If you don't have the discipline to stick with your underlying strategy particularly when it's not going in your favor, it's nothing. It's data on a page." - Jim O'Shaughnessy

Portfolio management can be broken down into two distinct camps -- macro and micro. The macro deals with investment plans, asset allocation, risk management and philosophy while the micro is more about individual strategies and security selection. Both are necessary components of portfolio management but are typically performed by different groups or firms in the financial industry.

[In my latest book](#), I quote Jeff Bezos who once said, "We are stubborn on the vision. We are flexible on the details." That's kind of the way I view my career in the investment management. My focus has been on the macro side of the equation, figuring out which investment strategies or funds (the details) should be used in concert with a long-term investment plan, allocation, and philosophy (the vision).

I've evaluated hundreds and hundreds of portfolio managers, funds, strategies, organizations and investment processes in a wide variety of asset classes and fund structures. The one constant from this experience is that pretty much every single person or firm states that what separates them from their competitors is their process. Every investment manager is a special snowflake. The tagline is always some variation of, "Our edge comes down to our unique investment process..."

But one of my biggest takeaways from the Great Financial Crisis is that the majority of these disciplined investment processes I kept hearing about got completely thrown out the window at the first sign of panic in the markets. An investment process means nothing until it's tested. And the majority of fund managers seem to have failed that test during the financial crisis in my experience.

I was reminded of this while listening to Jim O'Shaughnessy talk to his son, Patrick, this week on a podcast. Patrick asked Jim, a pioneer in the quantitative investment space, if discipline is the one feature that separates those who are successful from everyone else. This was Jim's response:

*Action without knowledge is foolish and knowledge without action is futile. It's the ability to, in a completely dispassionate way, let the portfolios work. And I ultimately have found that that is the single hardest thing to do. We had a consultant come in after the financial crisis and say, I think the number was sixty-plus percent of quants violated their models. And, as you know, that negates every part of the track record. Because if they're going to switch horses in mid-stream, they're no better than somebody who doesn't say they're a quant and changes their strategy dramatically.*

The stat Jim references about 60%+ of quant investors violating their models matches up pretty closely with my experiences during the crisis, whether the fund managers were quant or not. Everyone seems to tout a disciplined process until they actually have to be disciplined. Ideas are

overflowing in the investment industry but discipline and consistency are short supply.

Of course, there's a reasonable explanation for this. The past always seems easy to navigate in hindsight while the future is always uncertain. One of the hardest questions to answer as an investor is the following: Am I anchoring to an investment strategy that doesn't work anymore or staying disciplined to a good process?

There are no easy answers to this question because no one can predict the future, but investors still have to confront this situation and make sound decisions. Meb Faber recently talked to another legendary quant investor, [Ed Thorp](#), and asked him this million dollar question -- how do you know when it's time to put an investing system to pasture versus when it's time to invest more money? I liked Thorp's response:

*If I'm doing something that I think gives me an edge. I ask myself, "Did it work in the past? Is it working now? Do I think it's going to work in the future?" And I want to know what the mechanism is that's driving it.*

*You need to understand what the underlying average results ought to be. And how much normal chance fluctuations -- down is bad luck, up is good luck -- how much that can be and see if what is happening is outside that range. And if it is then you want to move on. If you don't have a reason for knowing why something works, then if it goes bad, you don't know whether it's bad luck or whether something changed.*

Thorp's answer here doesn't give investors 100% certainty, but you'll never get to 100% certainty about anything in the investment business.

This is my simple prescription for understanding whether you stay the course or move on from an investment strategy:

- **You must know your history.** How did it perform in the past? What environments does it work best in? What environments does it not do so well? How often does it work? What is the historical range of outcomes?
- **You must be able to assess the present.** Has anything changed that would cause the strategy problems? Who is your competition? What's your edge?
- **You must have a general idea of why something works.** Is it behavioral (other investors acting irrationally)? Is it risk-related (you're being compensated for taking more risk)? A combination of the two?
- **You must put things into context.** Back-tests are easy because you can optimize everything. You have to consider real world variables -- costs, taxes, market structure, competition, capacity, etc. -- when testing anything.
- **You must have conviction.** My favorite test for this problem is this -- if you're investing in a strategy that has poor five or ten-year performance would you be willing to double down

and add money when it's underperforming?

And above all else, you have to trust the people, team or organization implementing the strategy on your behalf. You don't want someone who changes course every time they see a poor outcome.

None of this is easy, but successful investing is hard.

Both of these podcasts are worth a listen:

[Premeditated Success, with Jim O'Shaughnessy \(Invest Like the Best\)](#)

[Ed Thorp: "If you bet too much, you'll almost certainly be ruined." \(The Meb Faber Show\)](#)

Now here's what I've been reading this week:

- Is the US stock market an anomaly? ([Alpha Architect](#))
- 15 obstacles we face as humans ([Humble Dollar](#))
- Getting out of the market is easier than getting back in ([Rekenthaler Report](#))
- Your greatest asset is you ([Of Dollars and Data](#))
- "Bad news smashes your face against an amplifier, while good news just plays quietly in the background." ([Irrelevant Investor](#))
- Netflix is set to take over the stand-up comedy game with a new special every week for the rest of 2017 ([Ringer](#))
- How being lazy helps make Michael Lewis successful ([Inc](#))
- The Eighth Wonder ([What I Learned on Wall Street](#))
- Once upon a time, there was a Trump rally... ([Bloomberg](#))