BijaAdvisors
Better Decisions, Better Results

Seeds of Thought

Cognitive Science Meets Investment Management

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The 20/80 Rule of Investment Management

Growing up, I was a mediocre student. Every report card had the same comment. "Stephen is highly intelligent and very capable. If only he would settle down." My parents were creative in their attempt to incentivize me to obtain top grades. They drove me around the wealthy neighborhoods pointing out the most ostentatious mansions, took me to the expensive car dealerships and brought home brochures of beautiful boats, all with the hope that an innate desire to acquire nice things would trigger a shift in my priorities. In high school, they even offered to buy me a new car if I was able to finish a semester with nothing but A's on my report card. I give them credit and I'm thankful that they cared enough to worry about me. Unfortunately, what they didn't understand is that I wanted straight A's as much as they did. A lack of motivation was never the problem.

My High School Graduation

Being a late bloomer, both physically and emotionally, I was perennially immature. Right up until I left for college, that immaturity was the explanation given for my hyperactivity and inability to focus on any task for more than a few minutes. However, when I continued to struggle with the same issues in college, it was clear there was more to it, but what could I do?

I followed all the usual advice and mimicked the behavior of the best students, but the results remained the same. My mind would drift and my energy knew no bounds. The first two years of college were a struggle even though I desperately wanted to do well, to get good grades and show everyone what I could accomplish. Finally, after struggling for 14 years, I had an epiphany. Rather than worrying about the outcome (grades), I would focus my effort and attention on the only thing I could actually control; the process.

I devised a radical new learning process for myself whereby I broke everything down into the most minuscule of tasks (bija). I created repetition exercises to essentially trick my brain into cataloging information properly. My system required constant vigilance, but was specifically adapted to accommodate my natural inclinations, allowing me to jump around from topic to topic in short intervals. It fundamentally flipped the traditional approach on its head. Whereas most students put in some work throughout the semester with the occasional burst of intense activity as exams approached, my method required short bursts of intense activity at the moment when material was introduced and dwindled down to literally nothing as exams approached.

So, while the libraries were packed until 5 am with caffeine infused students during exams, I had absolutely nothing to do. No notes to review, no books to read and no practice exercises to do. Nothing. It's difficult to explain just how uncomfortable I felt at that moment. I mean, I had no track record of success to give me any reason to believe that the system I devised for studying was better than the one

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followed by previous generations of incredibly smart students, not to mention every student on every campus at that exact moment. I was torn. On the one hand, I believed wholeheartedly in my method, for every facet of it was deliberately designed to be rational and effective, but that didn't quell my doubt. While I was incredibly relaxed and confident in my knowledge of the material, ironically, possession of that state of mind when everyone around me was so uncharacteristically stressed, worried me. In the end, my concerns were unfounded. I achieved straight A's, not just that semester, but every semester that followed. For the last two years of my undergraduate studies as well as my time in graduate school at NYU, I was consistently on the Dean's List and President's Honor Roll.

I learned many great lessons from the experience. Perhaps most of all was the realization that we can't control the outcome, only the process that leads to it. When you improve the process, when you make hundreds of tiny decisions even marginally better, you can dramatically improve your odds of achieving the results you desire. Ultimately, *that* is what you control. As it relates to education, what is within the student's control is the development and execution of a process that improves their odds of learning the material. When that happens, the grades inevitably follow.

The same goes for generating alpha. Daily, weekly, monthly, quarterly and even annual returns are not something you can choose. Instead, they are merely a reflection of the quality of the process that guides the millions of decisions made along the way. The better the process, the greater the likelihood each of those decisions will improve the odds of generating better returns. Simply coming to this realization can go a long way toward reducing your vulnerability to systematic errors in judgement, including hindsight bias. When all of the focus is on outcome, it can cause us to make mistakes in interpreting statistics, like overweighting small sample sets.

Consider this real life example. James Beecham and Brett Siever each drove to a party where alcohol was served. Brett had 6 beers before driving himself and 3 of his friends home. They played loud music and Brett even exchanged a couple of texts while driving. An hour later, while Brett and all of his passengers were safely asleep in their respective beds, James left the party alone. He hadn't had anything to drink the entire night, put his phone in the glove compartment before starting the car and never turned on the radio. He did everything exactly as his parents, and the odds had prescribed. Unfortunately, as James drove through an intersection, a driver who was under the influence of alcohol and had forgotten to turn on his headlights, went through a red light smashing directly into the driver's side door, killing James instantly. When that scenario gets played out hundreds, even thousands of times over the course of a year, the results are generally different and more reflective of the individual decision making processes. Nonetheless, on that night with a tiny sample set of two individuals, the end result was a poor metric by which to make a proper assessment of James and Brett's decisions.

In this example, it is clear that James had made better choices, and given the opportunity to repeat them over the course of many years, we would expect a better fate for James than Brett. So, in spite of the actual results, had James survived, no one would have suggested that he adjust his behavior going forward. We are smart enough to know that even the best decisions occasionally lead to poor results. Unfortunately, we aren't always that rational.

Consider another real world example. One of my coaching clients shared with me that she tends to cut her positioning following down months and increases it after up months. It's a very common process among investment managers. After analyzing her trading data, it turned out she was more systematic in this process than she even realized. We then ran a scenario analysis over her 7 year track record as a hedge fund portfolio manager where we made just one adjustment to her process. We unwound all of

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those reactive adjustments. In other words, after every down month we erased the downward size adjustment for the following month and vice versa for the up months, leaving everything else constant. With this and only this adjustment, here were the results.

	Actual	Adjustment Removed
Year 1	9.5%	16.0%
Year 2	7.1%	5.5%
Year 3	10.1%	9.9%
Year 4	10.3%	16.1%
Year 5	3.5%	2.7%
Year 6	9.8%	12.1%
Year 7	9.2%	14.8%
Average Annual Return	8.5%	11.0%

Think about that impact on her returns over those seven years. She had reduced her average annual return by a full 250 basis points, and her total return by 30% simply by focusing on the outcome rather than the process. (As an aside, which of those track records do you think yielded a better sharpe ratio? Which return stream would you prefer?)

Again, all we can control are our decisions, but not just those that are directly related to markets such as macro/micro analysis, valuation, technical analysis and historical returns. There's so much more to generating alpha.

Think about your typical day. How much of it is spent trying to figure out if the Fed will or won't, China will or won't, etc? Now, how much of your day is spent doing a similar analysis and investigation of your decision making process? How much time is spent quantifying your expectations, comparing your post-mortem against your pre-mortem analysis? How much effort do you put into developing and maintaining proactive processes ahead of the trade, versus fretting over the best course of *re*-action later on?

> "Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." - Warren Buffett

With decades of cognitive, behavioral and decisional research proving that we are all vulnerable to systematic errors in judgement, doesn't it make sense to make the effort and take the necessary steps to improve our decision making process? In order to shift the odds of success in our favor we must be deliberate in our approach, every step of the way. We must be vigilant in our defense against bias and suboptimal selections.

Think about your track record over the last year, or even the last ten years. Would you say your returns are an accurate reflection of your market views? If you're like most investment managers that I coach, you know you've probably underperformed them. I estimate that roughly 20% of your returns can be attributed to your investment and market analysis, with the remaining 80% being a function of your decision making process. Meanwhile, most professional investors spend upward of 80% of their time and research budget focused on the aspect that contributes just 20% to their bottom line.

Think about it on a grand scale across all market participants. How else do you explain the incredibly high correlation in views shared by market participants accompanied by a wide dispersion in returns?

> "The economics consultancy London Economics assessed the predictions of more than thirty of the top British economic forecasting groups, including the Treasury, the National Institute, and the London Business School. They concluded: It is a conventional joke that there are as many different opinions about the future of the economy as there are economists. The truth is quite the opposite. Economic forecasters . . . all say more or less the same thing at the same time; the

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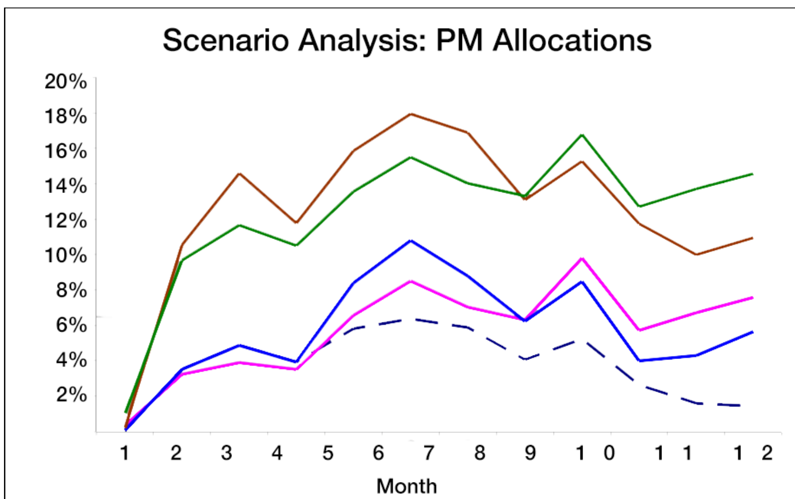
> degree of agreement is astounding. The differences between forecasts are trivial relative to the differences between all forecasts and what happens." - Mark Buchanan's The Social Atom

As a result, when I coach experienced investment managers, we spend very little, if any, time discussing the factors that account for the 20% impact. Instead we focus on the decision making process itself.

Here's another actual example from a coaching client. In this case, it's a hedge fund CIO. We began by discussing the evolution of the firm's first year in business which led to identifying key moments of significance, strictly from a managerial perspective. In other words, they bore no relation to market action or portfolio manager performance. We also limited the analysis to consider only those issues that were identified in real time, thereby avoiding the benefits of hindsight. In the end, *he* identified 4 alternative decisions that would have been more objective at the time. The navy blue dashed line reflected his actual allocation process. Holding everything else constant, including market views, execution, structuring and sizing, the alternatives would have added between 400 and 1400 additional basis points to the fund's returns.



The point I am making here isn't that I have all the answers. Instead, what I hope you take away from this edition is that your returns are dependent on so much more than knowing whether the Fed will or won't. When you come to that realization, you will begin to ask new questions, explore new ideas, realize greater potential, and, I expect, enjoy the process a whole lot more.

Let's Make a Deal

On the long running television game show, *Let's Make a Deal*, contestants are presented with a dilemma. The host begins by unveiling three numbered doors. He then explains that behind one of the doors is a brand new car, while the other two each contain a goat. The way the game works is, the contestant begins by selecting a door with the understanding that whatever is behind that door, the contestant gets to keep. After the initial selection is made, the host must then open one of the two remaining doors to reveal one of the goats. At that point, the contestant is given the opportunity to change their selection. The question is, should the contestant switch to the other unopened door?

Click here for the answer.

About the Author

For nearly thirty years, Stephen Duneier has applied cognitive science to investment and business management. The result has been the turnaround of numerous institutional trading businesses, career best returns for experienced portfolio managers who have adopted his methods, the development of a $1.25

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billion dollar hedge fund and 20.3% average annualized returns as a global macro portfolio manager.

Mr. Duneier teaches graduate courses on Behavioral Investing and Decision Analysis in the College of Engineering at the University of California. His book, *AlphaBrain,* is due to be published by Wiley & Sons in the Spring of 2017.

Through Bija Advisors' coaching and publications, he helps the world's most successful and experienced investment managers improve performance by applying proven, proprietary decision-making methods to their own processes.

As a speaker, Stephen has delivered informative and inspirational talks to audiences around the world for more than 20 years on topics including global macro economic themes, how cognitive science can improve performance and the keys to living a more deliberate life. Each is delivered via highly entertaining stories that inevitably lead to further conversation, and ultimately, better results.

Stephen Duneier was formerly Global Head of Currency Option Trading at Bank of America, Managing Director in charge of Emerging Markets at AIG International and founding partner of award winning hedge funds, Grant Capital Partners and Bija Capital Management.

His artwork has been featured in international publications and on television programs around the world, is represented by the renowned gallery, Sullivan Goss and earned him more than 60,000 followers across social media. As Commissioner of the League of Professional Educators, Duneier is using cognitive science to alter the landscape of American K-12 education. He received his master's degree in finance and economics from New York University's Stern School of Business.

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