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Intelligent Investing

Guy Fraser-Sampson

A Guide to the Practical and Behavioural Aspects of Investment Strategy

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What Is Strategy?

This is a book about investment strategy (the title being a bit of a giveaway). It will set out the way in which investors of all types and sizes can work towards identifying and implementing the approach to investment that is most likely to achieve their objectives. As will be seen, this process is infinitely more complex than might at first be thought.

The good news, however, is that it is complex rather than complicated. There is no individual part of the process that is inherently difficult in itself. However, the number of different issues which must be considered, not just individually but also in terms of how they affect and interact with all the others, does present a very real challenge.

That challenge is made all the more daunting by two aspects of the way in which we think. First, we have no experience of thinking strategically during our normal working lives, which are taken up with operational decisions relevant to our day-to-day responsibilities. Second, when we learn about finance and investment they are invariably presented to us as a science, most likely some form of mathematics, and thus we tend to approach investment matters by trying to apply the sort of rigorously objective and quantitative approach demanded by science in order to find the 'one right answer'. Asset allocation models, commonly called 'Optimisers' are good examples of this. As we shall see, however, the strategic process requires a completely different mind-set. Quantitative techniques, for example, are a necessary part of the process, but only a part, and they only take us so far.

More fundamentally, the process is often undone by people not actually understanding just what 'strategy' is, which at best leads to them skipping an entire (and vital) stage of analysis, and at worst renders the whole exercise largely meaningless. This, then, must be our starting point.

In part, the confusion arises because the terms 'strategy' and 'tactics' are often, rather sloppily, used interchangeably in everyday speech when in fact they have quite different meanings and applications. This difference is well appreciated in the field of military affairs, within which much work on strategy has been published, and so perhaps we may begin our discussion of strategy by distinguishing between the three different levels at which thinking and planning should take place: strategic, tactical and operational. We might illustrate this by using as an example the Second Battle of El Alamein in 1942.

The situation at this time was that the German and Italian forces, under German Field Marshal Erwin Rommel, had fought their way to the boundaries of Egypt in a series of brilliant manoeuvres, aided and abetted by some very indifferent generalship on the part of the Allied forces. Recognising these shortcomings almost too late, the Allied Commander-in-Chief, Sir Claude Auchinleck, had dismissed his army commander and taken personal control of proceedings. Snatching victory from the jaws of defeat, he halted Rommel at the First Battle of El Alamein. Most commentators now recognise that this marked the turning point of the desert war. Rommel was left too weakened to dislodge the Allies from their defensive positions, and could not bypass them without being struck in the rear and flank if he did so; Auchinleck had in fact already attempted to do this as the battle drew to a close, but had been let down by his subordinate commanders, who had developed the habit under his predecessor of treating orders as voluntary guidelines.

Auchinleck none the less realised that Rommel's stubborn persistence would not let him admit that the game was now over without at least one more roll of the dice, and so he prepared to fight another defensive battle along the ridges protecting his position to the south. However, at this juncture, Auchinleck was abruptly sacked by Prime Minister Winston Churchill for political reasons. He was replaced as Commander-in-Chief by Field Marshal Harold Alexander, and as army commander by Lieutenant-General William Gott, yet another highly questionable decision by Churchill, since Gott as a corps commander had been one of the prime offenders during recent months when it came to disregarding orders. However, Gott was killed in a plane crash while flying to take up his command, and so it was Bernard Montgomery, the future Field Marshal, who was to fight what became known as the Battle of Alam el Halfa, using Auchinleck's plan and his dispositions, as Rommel made his final forlorn attempt to break through. Finally recognising defeat, Rommel settled into prepared defensive positions opposite the allies at El Alamein before departing for medical treatment in Germany. Thus the initiative had shifted decisively to the Allies, especially as they were supplied with substantial reinforcements, including two entire armoured divisions, and hence enjoyed a considerable numerical advantage.

Let us first examine the strategic issues that now faced Alexander and Montgomery. Strategy relates to the big picture. Because it is the starting point, it is vital that we begin at the very top of the pyramid of issues and decisions. We must identify those things that are fundamental, that operate upon other things, but which are not themselves operated on by anything but themselves. In military terms this translates into 'How can we best win the war?'.

It is in fact very rare for generals to have to address truly strategic issues in a battlefield context. Such decisions are usually taken by ministers and defence chiefs in solemn conference some time previously, and at a distance. That is what makes the Second Battle of El Alamein so interesting, and such a useful example.

You see, what Alexander and Montgomery knew was that Winston Churchill and the US President Franklin D. Roosevelt had agreed to launch Operation Torch, the invasion of North Africa from the west, and that these attacks would be taking place a few weeks hence. When they did, the Axis forces opposite El Alamein would be forced into a lengthy and hasty retreat as they scrambled to link up with their counterparts in the west before the Allied forces could get between them and cut their supply lines. Thus, in addressing the strategic question of 'How can we best win the war?' they had a very fundamental decision to make: should they actually fight the battle at all? Would launching an attack contribute anything significant to winning the war, or would it be more sensible to hold all their mobile forces, and particularly their tanks, ready to pursue the enemy as it withdrew, and, it was hoped, to destroy its forces (or at the very least inflict significant losses and dislocation) as they did so?

With the benefit of hindsight it is easy to see that Alexander and Montgomery made the wrong decision. The Allies were to suffer more than 13,000 casualties, would at various times come close to losing (or at least failing to win) the battle despite their overwhelming superiority, and even after it was over, timid generalship by Montgomery would allow the Axis forces, once again under the command of Rommel, recalled from his sickbed, to slip away to the west after all, albeit being only a shadow of their former selves.

This is a classic example of emotion and politics being allowed to interfere with the rational process, something which, alas, happens in business and finance all the time. Montgomery wanted his battle to prove his credentials as a general, and prove he was superior to Auchinleck (though, ironically, if anything it did the opposite, though this was not recognised at the time). There is also a sense that the British realised, from Torch onwards, that they would be the junior partners in the alliance, and that this represented the last chance for a 'British' (in fact largely Indian, Australian, New Zealand and South African) army to show that it could inflict a decisive defeat on the German forces. Again, ironically, it would prove to be a technical victory but a moral defeat; with their superiority in men and equipment, and enjoying total control of the air, the 'British' should have won easily, and on schedule.

This, then, is the strategic level. As we shall see, it is driven by big, fundamental questions such as 'Who are we?' and 'What are we trying to achieve?'

One level down from this come tactical considerations, which might be characterised by the question: 'How do we win this battle?'. Viewed in this way, the difference between strategy and tactics, and the danger of confusing the two, will, it is to be hoped, be obvious. Yet it is a common confusion; in my experience most investors largely ignore the strategic level and go straight to tactics. Because of this they are, of course, holding their discussions in a vacuum. Tactics are supposed to be the means of implementing a discussed and agreed strategy. On their own, they are largely irrelevant; they are a means, not an end.

The management writer, Peter Drucker,[1] summed this up perfectly when he pointed out that it is far more important to do the right thing (even if done imperfectly) than to do things in the right way. Doing the wrong thing well and energetically can be disastrous. Drucker reinforced the distinction by urging us to think about strategy as 'effectiveness', and tactics as 'efficiency'. Strategy is about choosing the optimum (most effective) course of action. Tactics is about how well (efficiently) we execute it.

At the Second Battle of El Alamein, Montgomery had a choice between making a broad flanking manoeuvre out into the desert to try to avoid the Axis fixed defences and to find a way round them to the south, or to attack them frontally. He chose the latter, partly because his temperament required him to fight a tightly controlled battle, but perhaps partly because he was unfamiliar, and thus uncomfortable, with the wide expanses of the desert after his experience of the relatively confined battlefields of Northern Europe, and partly because he lacked confidence (with some justification, given their recent history) in his subordinate commanders to follow orders.

His tactics chosen, he then had to decide how best to implement these on the ground, at the level of the individual unit. This is what is called the

1. Peter F. Drucker, *The Effective Executive*, New York: Butterworth-Heinemann, 2007.

operational level, and these decisions are often left to subordinate commanders, but Montgomery wanted to control every aspect of the battle, and therefore laid down very carefully what was to happen, even briefing individual battalion commanders personally.

In this case, the Axis defences were protected by deep minefields, which were in turn covered by anti-tank guns. Montgomery therefore directed that the infantry (since there were not nearly enough engineers to do the job on their own) should clear narrow lanes through the minefields for the tanks to use. This was done by the simple, though highly dangerous, expedient of walking slowly ahead (while being shot at), and poking the ground with a bayonet. The fact that troops in Afghanistan had to resort to an identical procedure some 70 years later is a sad comment on the ongoing failure of the British army to supply its men with the right tools for the job.[2]

So there we have the three levels of decision-making: strategic, tactical and operational. Clearly, they are listed in declining order of importance. Getting your infantry platoon moving ahead smartly will not be much use if you are advancing towards the strongest, rather than the weakest, part of the enemy line. Similarly, even if your battle plan is a model of intellectual rigour, it will not help you if, while you are busy winning this battle, a different enemy force is cutting off your communications and supplies. Nor if your leaders are ordering large parts of your forces off to different theatres of war (as happened with some of Montgomery's predecessors), so that you will be unable to follow up your victory even if you achieve it.

The levels of decision-making are also stated in declining order of their easiness to change. If your platoon is pinned down by an enemy machine gun, it is a relatively simple matter to send half a dozen men off to outflank it while the rest provide covering fire. If you decide that a whole division is attacking in the wrong place, it can take several days (as it did at El Alamein) to move it and all its support echelons from one location to another. Trying to change your strategy in midstream (as the British and French did when they dithered over invading Norway in 1940) leads to whole shiploads of troops and supplies being, loaded, unloaded, reloaded and re-routed. Ensuing disaster, as in that case, is usually both predictable and inevitable. As another management guru, Michael Porter,[3] said: 'strategy must have continuity; it can't be constantly reinvented'.

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2. This 'BARMA-ing', as it became known in Afghanistan, should in any event have been unnecessary had the Government supplied the troops with helicopters so they did not have to travel on the ground, as happened with their American counterparts.

3. Keith M. Hammond, 'Michael Porter's Big Ideas', available at www.fastcompany.com.

It follows, then, that strategic decisions have far more impact than tactical ones on resulting events, even though they may seem to be more remote from the decision. There is research that purports to show this. A 1991 study,[4] following from an earlier one undertaken in 1986, found that asset allocation (strategic) decisions accounted for over 90 per cent of investor outperformance when compared with manager selection (tactical) decisions. Note the word 'purports'. This study has been rightly criticised for ignoring the effect of management fees. It is also only fair to point out that the asset types considered were a fairly narrow selection, as was customary at the time. Its methodology in calculating returns has also been queried.[5]

However, while the extent to which the outcomes of strategic decisions outweigh those of tactical decisions may be open to question, the general principle is not. A peer-reviewed academic paper published in 2000,[6] which looked at mutual funds rather than pension funds (as the 1991 one had done), broadly supports this, while refining the questions asked. It finds that effectively 100% of an individual fund's outperformance may be ascribed to strategic asset allocation (using what the study calls 'the policy return'). However, when it comes to comparing any one fund with any other as an external observer, such as a financial analyst seeking to choose between them, asset allocation explained about 40 per cent of the variation in returns. Whatever the case, it seems clear that, for investors, it is asking the right strategic questions, and answering them correctly, that will account for most, if not all, investment outperformance.

All of which strongly suggests that any investment decision-making body, such as the investment committee or board of trustees of a pension fund, should spend at least 90 per cent of their time discussing strategic issues (choosing the right asset types) rather than tactical issues (choosing the right managers). After all, if you have chosen the wrong asset type in the first place, then what difference does it make if you happen to choose one or two managers who may outperform against their peers within that mistakenly chosen asset class? Drucker says that doing the wrong thing very efficiently is frequently worse than doing nothing at all – and academic studies support him. They show that choosing the right asset types may account for almost all of outperformance, whereas

4. Brinson, Gary P., Singer, Brian D., Beebower, Gilbert L., 'Determinants of Portfolio Performance II: An Update', *Financial Analysts' Journal*, vol. 47, no.3 (1991).

5. William Jahnke, 'The Asset Allocation Hoax', *Journal of Financial Planning*, February 1997.

6. Roger Ibbotson and Paul Kaplan, 'Does Asset Allocation Policy Explain 100%, 90% or 40% of Performance?', *Financial Analysts' Journal*, vol. 56, no.1 (2000).

choosing the right managers (particularly within the wrong asset type) may account for almost none.

Yet any one who has attended the meetings of such a body will know that in fact the opposite is true. Whole meetings can pass without a single strategic issue being raised, with the attendees proceeding robotically through a fixed and packed agenda, quizzing managers on past performance, and asking consultants for ever more complicated analyses of it, all incidentally based on the fundamental and unquestioned assumption that the future will simply be a repeat showing of the past for those who were unlucky enough to miss out on it the first time round.

For those who glimpse the true significance of the bigger picture, such meetings are at best tedious, and at worst futile and frustrating. Yes, choosing the right managers can make an enormous difference in some areas, such as private equity, but only if you have first chosen the right asset types, and made sensible allocations to each. These asset allocation decisions can only properly be the output of the strategic process, and the fact that so many investors get them wrong is usually because they have never attempted the process at all, but simply chosen them on some random and arbitrary basis.

If you are someone who attends such meetings, then you can easily test this for yourself. Simply ask 'Why?' every time someone makes a statement. If a strategic process has been undergone successfully, then those running the meeting will have a ready and rational answer on each occasion.

Strategy	**Tactics**
Influences lower level (tactical) decisions, but can itself only be influenced by external factors and changing circumstances	Influences lower level (operational) decisions, but is itself designed to implement higher level (strategic) decisions
Big Picture: How can we win the war?	More specific: How can we win this battle?
Doing the right thing (Drucker)	Doing things right (Drucker)
Effectiveness (Drucker)	Efficiency (Drucker)
Making the right asset allocations	Choosing the right managers
Produces 90–100% of outperformance across a whole fund (academic studies)	Produces 0–10% of outperformance across a whole fund (academic studies)
Vital to succeed. Fatal if you fail	Good to have. Failure will impact adversely on performance to some extent

Figure 1.1 Strategy and tactics

What of the third level, the operational? Well, if strategic decisions are about which are the right assets to hold, and tactical ones about which managers to choose (these are deliberate simplifications at this stage – as we progress you will see that there is much more to it than this), it follows that everything below this must belong to the operational sphere. In front office terms this will mean conducting due diligence on proposed investments and managers; the monitoring of existing investments and managers; and, if appropriate, rebalancing between asset types. In back office terms, it will involve the transfer of funds, accounting for these, and supervisory oversight to ensure compliance with both internal procedures and external regulations. Depending on how your investment process is organised, it might also entail custodianship and brokerage arrangements, as well as all the data entry surrounding the managers reporting to you, and you in turn reporting to your board or committee.

Of course, where these activities – such as due diligence and monitoring – result in manager selection or de-selection decisions, or go/no-go decisions on direct investments, then it is easy to allow everything to start blurring together, but this should not conceal the essentially different nature of these activities. Rarely will those who undertake due diligence also have the authority to make an investment decision based on it (though they may participate in the discussion).

It is also important to understand one basic difference in the way in which the top two levels interact, compared to the bottom two. In both cases there is (or should be) a feedback loop, but this works slightly differently in each case. Where a strategic decision has been made (for example, to allocate 15 per cent to real estate), it may subsequently prove impossible to implement this effectively, in which case the issue will loop back to those who determine strategy to see if they wish to change their minds. Of course, this should not happen, except where circumstances such as market conditions have changed unexpectedly, since the ability to execute on a strategy should have been fully considered when it was set, but happen it does.

In the case of some operational matters, these can be undertaken to allow, or at least to facilitate, the making of tactical decisions. For example, a tactical decision may be taken to favour a particular manager in principle, but detailed due diligence may then be required to decide whether to actually go ahead and appoint that person. It will be comparatively rare for a tactical decision to prove impossible (rather than merely unwise) to execute, and when this does occur it normally does so as a result of internal systems, whether accounting or IT, proving unequal to the challenge.

Of course, in practice, particularly in small organisations such as thinly staffed pension funds, there may be a considerable cross-over in terms of who makes which decisions, and this inevitably makes it more difficult to keep the three levels strictly separate in one's mind, but no matter how difficult this might be, or how artificial it might seem, it is essential to do so. Conducting the strategic process is difficult enough to start with, but once irrelevant or inappropriate issues are allowed to crowd in, it rapidly becomes downright impossible.

Perhaps this is another reason why the strategic and the tactical tend to get confused in practice. If the same people are responsible for both, then there is a temptation simply to start with the existing investment process (tactical/operational) and discuss how this might be improved, rather than asking more fundamental (strategic) questions, such as in which types of assets the organisation should be investing, and why.

Remember that little word, by the way. 'Why?' is the most useful weapon in our strategic armoury. It is our equivalent of Cartesian doubt. By asking it repeatedly we strip away layer after layer of assumptions and conclusions until we get down to the real starting point. Unfortunately for those who are involved on the operational side of things, there seems to be an inbuilt readiness to start with the 'how?' and the 'what?', but these should form part of the output, not the input.

Always bear in mind the objective of investment strategy, which is to arrive at the optimum mix of assets for any single individual investor – 'optimum' in the sense that it is what is most likely to achieve their desired outcome. So, asset allocation should mark the finishing line of the process, not the beginning, as it frequently seems to do in practice.

Why an 'individual' investor? Because no two investors are likely to have exactly the same desired outcome, or at least should not have if they have conducted their process properly, and so it will be almost impossible for exactly the same mix of assets to be optimum for both. Look out for asset mixes that are suspiciously similar to those of other investors, particularly if they are of the same type and geography. Ditto peer benchmarking, where an investor simply adopts as a target rate of return what is aspired to by supposedly similar investors (in reality, simply those with the same label on the tin). Both of these are usually clear indicators that the strategic process has failed, or never even taken place.

It is the need to fix on a desired outcome that drives the whole process, and will, one hopes, prompt thinking that helps to define an organisation's view of itself. 'What are we trying to achieve, and why?' should be a constant companion to the strategic discussion. Staggeringly, this question is rarely asked by boards or investment committees, and even when it is, it tends to be pursued in isolation rather than as the starting point for a wider strategic analysis. Michael Porter again: 'sound strategy starts with [having identified] the right goal'. Incidentally, little in history is new, and certainly little to do with strategy. Writing in the first century AD, the Roman thinker and politician Seneca said that if a sailor does not know which port he is making for, he is unlikely to find a favourable wind.

Knowing your destination is one thing. Most of us can find a large town on a map. Much more difficult is being dropped in open countryside from a closed truck with a map and a compass, and trying to work out your current location. As we shall see, it is just as important to identify the starting point of your journey as it is to know in which direction you are headed. Many recently parachuted secret agents on both sides were caught out during the Second World War by being unable to point to their location on a map when questioned. Similarly, any attempt to set investment strategy without first working out exactly where you stand to begin with is doomed to failure. Yet this is all too common an omission, not least because the emotional need to conform to the conventional wisdom within the organisation is nowhere stronger than in actually considering the organisation itself.

So, everything we have learnt so far could be summed up by the phrase 'strategy is important' or 'strategy matters'. Yet this does not really go far enough. Strategy is more than important. It is vital and fundamental. None of us would set out on a car journey without first deciding where we wanted to go, considering how to get there, and whether we have enough fuel in the tank. Yet these basic questions are exactly what most of the world's investors neglect. Instead, they set out on an aimless tour of the surrounding countryside, choosing their turns at random, and trusting to luck not to run out of petrol along the way. Without wishing to be cynical, there is, of course, one advantage to all of this if viewed from a certain angle. If you have not actually committed yourself to any definite destination or time of arrival, then you cannot be said to have had an unsuccessful journey, regardless of where you end up or when you run out of fuel.

Frequently, strategic failure may be traced to one of these factors, whether alone or in combination with others. Yet staggeringly often the truth is starker still. Most investors simply never do any proper planning or analysis in the first place. Given the many difficulties that may arise during the process, and the various sensitivities that might need to be accommodated, then it would be tempting to assume that this is because the process has been considered, but then discarded into the 'too difficult' box. Yet this is rarely the case. What is much more common is that the need for strategic vision has simply never occurred to any senior employee within the organisation.

The word 'vision' prompts a couple of interesting points that need to be properly understood before we can travel any further on our journey of discovery. First, vision is not the same thing as strategy. The world is full of chief executives who can talk convincingly and passionately about their organisation's 'vision'. In the event, 'vision' usually turns out to be an emotive and frequently idealised view of the world as one would like it to be. Yet ideals, splendid though they may be in other fields, are dangerous things when it comes to strategy, whether military, corporate or investment. They are noble goals which can be set as outward symbols of the corresponding nobility of thoughts and intentions, yet they are rarely practical ones.

Often they are completely unattainable: sometimes because they involve unrealistic expectations of human behaviour – expecting it to be devoid of greed, fear or self-interest; sometimes because they require levels of technology that do not exist at present; sometimes because they ignore regulatory or other constraints to which the organisation (and others) are subject; and sometimes because they assume a readiness to incur a cost, whether financial or otherwise, that may prove unacceptable.

Strategy is different. Strategy is about what might be achieved in the real world with the resources actually at one's disposal, not what might be achieved in a notional world with the resources one would like to possess, but do not. Strategy is about reality, and translating an actual today into a manageable tomorrow. Vision is about aspiration, and some sort of utopian future.

Second (and this should be apparent from what has just been said), vision has the potential to be a powerfully disruptive element in the strategic process. For the process to achieve a successful outcome requires the rigorous application of reason in analysing the relevant facts and issues. This must by definition be dispassionate, since emotion is the enemy of logic. Yet vision cares little for reason, and can itself be an overwhelming emotional force. It is vision which creates the intellectual no-go areas that effectively doom many strategic reviews to failure from the outset. This is one of several reasons why, as will be explained in Chapter 3, the process is best run by a third party facilitator. An outsider will recognise vision for what it is, and try to keep it locked firmly outside the room while the debate takes place. Yet this itself raises grave difficulties, which we shall explore shortly.

The other problem about vision is that what it represents are essentially the shared values of the members of the organisation. This in turn assumes that the stated vision is the outcome of some sort of *Gestalt*, a collection of human minds that have come together to function as one, rather like a supercomputer. Yet, of course, this is not the case. It really represents what has been called the *koinos kosmos* (shared world).