ASSETTE

Rethinking Investment Philosophy

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A recent CFA Institute *Financial NewsBrief* survey asked readers what they most often emphasized as their main source of competitive advantage when seeking new clients. The most frequent response was "investment philosophy" (Fender 2015). Our anecdotal experience suggests the same.

But does investment philosophy mean the same thing to all who proclaim its importance? In our experience, some investment managers use the term to describe a set of deeply held beliefs about how to approach investing. Others seem to use it mostly for marketing. Some, we suspect, use it for both.

We believe the most useful investment philosophies accomplish multiple objectives. They encapsulate deeply held beliefs about how markets work and provide guidance for exploiting those workings on behalf of clients. In addition, a well-crafted investment philosophy statement can be a useful marketing tool that establishes the conceptual foundation for the firm's brand promise and sets a baseline for client expectations in their relationship with the manager.

The purpose of this paper is to describe our view of what a multi-purpose investment philosophy looks like. We begin with our definition of investment philosophy, followed by a discussion of some of the common misunderstandings and myths we believe many investment professionals attach to the term. We then discuss why philosophy should matter to investment professionals and close with the attributes that comprise a robust investment philosophy.

WHAT IS AN INVESTMENT PHILOSOPHY?

An investment philosophy is a subset of the broader concept of philosophy, which we define as a set of principles or beliefs that guides one's approach to a problem or endeavor.[1]

A philosophy can be thought of as a set of rules of thumb about how to approach the task at hand, as in "you can never use too much garlic" or "treat others as you would like them to treat you." Some philosophies are absolute and immutable, like some religious creeds, while others embrace the possibility of change. Modern professional knowledge is an example of the latter. Professionals must continuously seek out and assimilate new knowledge to remain competitive and helpful to their clients. That knowledge derives both from the scientific method and from the practical, in-the-field experience of the professional.

Beliefs That Guide the Investor

Within this broad concept of philosophy, what constitutes an investment philosophy? We define it as *"a set of beliefs that guides an investor's approach to investment management."* This definition is deliberately general. It applies to any investor in any setting. Our definition also applies to active managers, whose philosophies are rooted in the belief that they can outperform investable passive alternatives.

In this paper, we limit our focus to active management investment philosophies, since active managers are most often called upon to articulate and defend the beliefs that shape their approach to investing.

Core Components of an Active Management Investment Philosophy

Active managers face formidable challenges. Both theory and evidence suggest that consistently outperforming a passive alternative is, while not quite impossible, about as difficult as becoming a world-class athlete or musician. One is unlikely to succeed without being deliberate about the endeavor. For active investment managers, the central question is: how do you outperform a passive alternative most of the time?

Answering this question constitutes having a point of view about how the financial markets work, how investment opportunities occur, and the skill set necessary to profit from those opportunities before others do. These beliefs are the foundational principles—worldviews or mental models, if you will—that define a manager's approach to their craft.

In our view, therefore, an active manager's investment philosophy must address their beliefs about the following (Minahan 2006):

1. How the security pricing mechanism works and why it is that some securities are priced more attractively than others.

2. The skill sets necessary to identify and exploit attractive opportunities before prices move to eliminate the attractiveness of the opportunity.

WHAT IS *NOT* AN INVESTMENT PHILOSOPHY?

An investment philosophy is about beliefs that drive judgment and decisions; it's about how one thinks. In our view, the following implementation-oriented concepts, while closely related to philosophy, are often confused with, and presented as, an investment philosophy:

- **Investment Strategy:** An investment strategy is the application of an investment philosophy to a specific set of opportunities. A strategy is an approach for practicing beliefs, including beliefs about internal skills, portfolio construction and risk management. A set of beliefs provides the foundation for formulating an approach to add value to clients through investing.

- **Investment Process:** An investment process is a set of decision steps for executing an investment strategy. Beliefs permeate every aspect of the process—including the definition of the steps and execution for individual opportunities—but describing the steps one goes through to make decisions does not shed light on beliefs that guide judgment and the decisions.

- **Investment Style:** In the early days of an investment industry grappling with how to classify various approaches to investment management, the concept of style may have meant something close to philosophy. But today, it seems to us that style is primarily concerned with how managers plot on various two-dimensional grids, such as growth/value vs. capitalization. Investment style may help categorize a manager, but it does not provide a complete picture of beliefs that drive decisions.

- **Investment Objective or Goal:** A return objective or capital protection statement is what a particular strategy aims to achieve for clients. Philosophy is about how investment professionals believe they can achieve these goals, instead of a statement of the goals themselves.

FIVE MYTHS ABOUT INVESTMENT PHILOSOPHY

In addition to observing confusion between belief and implementation, we constantly encounter what we believe to be myths about what constitutes a "good" active management investment philosophy. We use five of these myths to illustrate what an investment philosophy is and what it is not.

Myth #1: Investment Philosophies Should be Data-driven

Many fields and individual practitioners in those fields pride themselves on being data-driven. We presume what they mean by this is something akin to the Wikipedia definition: "Data driven means that progress in an activity is compelled by data, rather than by intuition or personal experience." Perhaps they also mean they use data-driven decision management, which TechTarget defines as "an approach to business governance that values decisions that can be backed up with data that can be verified."

We think "What do the data say?" and "What data would I need to confirm an intuition- or experience-derived belief?" are good questions, and ones that should be asked in order for an investment philosophy to remain vital and grounded in reality. But we do not think that an investment philosophy should be *driven* by data.

To say an investment philosophy must be data-driven asks more of data than it can deliver. Furthermore, we believe that intuition and personal experience are key ingredients in the development of any belief system, and an investment philosophy is no different.[2] Further, not all convictions about the markets—or good investment decisions—can be backed up with verifiable data.

The nature of investing is such that data alone will not take an investor from an opportunity set to a decision. Data can narrow the range of the opportunity set under consideration, but at some point, investment professionals must make assumptions, rely on intuitive leaps, use rules of thumb, and mimic others. In other words, they must make judgments to take them from a set of opportunities to the portfolio they want to hold. The nature of investing is to act now on the expectation of future events, and investors are rewarded for being correct ahead of the competition. Sometimes the data don't reveal themselves until the future has become the past.

Our view is that philosophies should be data-engaged, not data-driven. By data engaged, we mean that holders of an investment philosophy should (Minahan 2008):

- Be aware, or strive to be aware, of the data that bear on the problems the philosophy is meant to address and attempt to learn as much as they can from this data.
- Think about what data would be useful to validate their core beliefs and strive to gather that data.
- Modify their beliefs, as appropriate, based on a holistic consideration of such data within the context of their professional experience and intuition.[3]

Myth #2: An Investment Philosophy Should Not Change Over Time

The beliefs that comprise a philosophy are, by definition, deeply held. However, even deeply held beliefs should be open to re-examination if the facts that bear on those beliefs change.

If we take a cue from philosopher and psychologist William James (1896), we can divide the world into those beliefs that are supported by data, those that are contradicted by data, and everything in between. Beliefs that are neither supported nor contradicted by data—the middle ground, as it were—are constantly migrating to the other two categories as new data emerges and new things are learned.

Because an investment philosophy may be built, in part, on beliefs from this middle ground, it needs to be *living.* That is, it must grapple with confirmation and disconfirmation as it is used in practice and as the world changes, and be open to new learning.

This doesn't mean a philosophy should be constantly changing, merely that it should be open to change if that is what the ongoing development of knowledge requires. This is another area where a data-engaged, as opposed to a data-driven, approach can inform, rather than define, a manager's investment philosophy.

Myth #3: Investment Philosophy Statements Should be Short and Simple

To paraphrase a sentiment widely attributed to Albert Einstein, a philosophy should be as simple as possible, but no simpler. The keywords to us are "no simpler."

Effective communication often calls for short, punchy statements. Yet many investment philosophies are richly layered and nuanced. They deserve full, if succinct, expression, and cannot be easily reduced to an elevator pitch without losing content. One solution to this dilemma is to develop multiple versions of one's investment philosophy statement. For example, it may make sense to have a short summary statement for use in marketing presentations and a detailed description to serve the needs of clients, consultants and internal investment staff seeking a deeper understanding of the firm's belief system.

Myth #4: All Members of an Investment Team Must Share an Investment Philosophy

We believe it is too strong a statement to say that all members of an investment team must embrace every tenet of the philosophy in lockstep. It would be more realistic to expect that they have compatible beliefs. While team members may have their own sets of beliefs, those beliefs should overlap enough for them to be able to work together to add value for their clients.

Beliefs may also differ within a team due to different levels of experience and tenure among its members. A new team member may take a while to internalize the team's philosophy. Of course, some firms attempt to avoid this by hiring professionals who already share the firm's philosophy.

Despite the inevitability and desirability of diverse beliefs across a team, a strong set of overlapping beliefs is needed to effectively execute investment decisions. As noted earlier, at some point, active managers must make decisions based on judgment. The key is to find the right balance between diversity and overlap of beliefs.

Myth #5: Each Investment Manager Should Have a Unique Investment Philosophy

We often hear investment and marketing professionals say that their philosophy is what makes their firm unique. We have also encountered investment consultants and other evaluators who expect each manager to have a unique philosophy. Perhaps they don't really mean "unique." Maybe what they expect is "distinctive." But if they actually mean one-of-a-kind unique, we think this is a mistake.[4]

A firm's philosophy should be an anchoring element of its identity, and it may well differentiate the firm from many other firms. But the investment philosophy doesn't need to differentiate the firm from *all* other firms. Stated differently, a particular manager does not need to be the only firm in the world that has a particular philosophy in order for that philosophy to be valid.

A common variant of Myth #5 is: *An investment firm must only have one investment philosophy.* We believe an investment firm should be able to articulate a sound investment philosophy for every investment strategy it offers, regardless of whether that strategy is packaged as one product or several related products.

A firm with a narrow investment focus might well have only one investment philosophy. For multi-strategy firms, it would not be uncommon for each investment strategy team within the firm to have its own investment philosophy.

Until now, we have attempted to define the concept of investment philosophy, and we hope you have a clearer picture of this somewhat abstract concept. Going forward, we make the case for the importance of philosophy to investment professionals.

WHY DOES INVESTMENT PHILOSOPHY MATTER?

There are many aspects of life where one doesn't need a philosophy—walking, for example, or breathing, or blinking one's eyes. But when faced with more complex endeavors, ones that require choices and where decisions must be made, and made in an environment of uncertainty, ambiguity, or nuance, most people look to their deeply held beliefs for guidance.

Active managers make decisions in a dynamic and complex environment, and are forced to do so before investment opportunities evaporate due to the actions of other market participants. Investment decisions of active managers have far-reaching consequences for themselves, their firms, their clients, and the beneficiaries of clients' funds. Given these conditions, a set of practically tested, theoretically sound beliefs about the markets—an investment philosophy—provides clarification and guidance to active investment managers in three areas:

- Defining the overall approach to investing and decision making.
- Framing internal communication and risk management.
- Facilitating external communication.

Defining the Overall Approach to Investing and Decision Making

An investment philosophy acts as a foundation for formulating an investment strategy that can potentially outperform passive options. Beliefs provide guidance for identifying the space managers wish to invest in and cues that may indicate attractive opportunities within that space. Philosophy also helps with product design, including formulating investment guidelines and assessing capacity constraints.[5]

These efforts require judgment. Judgment involves generating explanations for past and future events—interpreting cause and effect, and creating mental narratives about the events (Hogarth 1991). The higher the accuracy of cause-and-effect interpretations, and the more overlap between narratives and reality, the higher the quality of decisions, which increases the chances for adding value to clients. An investment philosophy provides context for narratives and helps make sense of the financial world. Beliefs provide clarity to observation, analysis, and interpretation.

In addition, maintaining a written record of the mental narratives behind specific investment decisions helps introspection. As the future becomes the past, introspection enables managers to understand the accuracy of their hypotheses: Did the future unfold as expected? What was the overlap between our narratives and reality? What are the reasons behind any disconnect between the narratives and reality? Even if the outcome was profitable, was it for the hypothesized reasons? Introspection helps update and adjust beliefs, leading to continuously improving investment decision-making, and potentially, outcomes. Also, during challenging times, knowledge gained through introspection and deeply held beliefs, coupled with accumulated experience, helps managers stay disciplined.

Framing Internal Communication and Risk Management

An investment philosophy lends context for discussions within the investment team as they consider choices. Sounding out arguments for a particular investment opportunity helps foster team consensus and promotes constructive dissent.

When deliberating each member's mental narrative about a particular opportunity, overlapping portions of the narratives bolster the case for that opportunity. Discussing reasons for non-overlapping portions, and especially reconciling differences, promotes appreciation of potential risks. Alternative viewpoints help the team analyze investment opportunities from different angles, which can reduce confirmation bias and groupthink. A variety of perspectives helps promote cognitive diversity in the investment team (Mauboussin 2013).

An investment philosophy also helps new members assimilate into an investment team. A well-articulated set of beliefs helps new people understand the worldviews of existing members, how they overlap with their own views, and how non-overlapping portions fit into the conversation.

Facilitating External Communication

An investment firm's core beliefs shape how it is viewed by external entities. They set expectations for investment decisions and results, and are an implicit part of the contract between manager and client.

Investment philosophy also helps consultants and potential clients identify a manager's place in their constellation of options and therefore facilitates multi-manager portfolio construction. When awarding mandates to multiple active managers, using managers with different philosophies helps diversify the approaches to investment management, even within a particular investment style.

Further, an investment philosophy plays an important role in client communication and retention. Continuously reaffirming the firm's philosophy to clients and consultants reminds them what the manager believes and why the manager was hired. A good philosophy helps illuminate the reasoning behind specific buy, sell, or hold decisions. When clients and their consultants understand a manager's worldview and see how that view manifests in decisions, they come to trust the manager's integrity, which in turn fosters loyalty and supports client retention.

ESSENTIAL ATTRIBUTES OF A ROBUST INVESTMENT PHILOSOPHY

We have defined investment philosophy as *"a set of beliefs that guides an investor's approach to investment management."* In order to be useful, those beliefs must address how investment opportunities come about, why some opportunities are more attractive than others, and how the manager identifies and exploits those opportunities before others do. In our view, these are mandatory components of a meaningful investment philosophy.

In addition, we believe an active management investment philosophy should also embody the following essential attributes:

- **It should be conceptually grounded.**
  A good philosophy needs to go beyond broad statements such as "We believe the markets can be inefficient." In order to be meaningful, it must set forth a logical framework for that belief and explain *why* inefficiencies exist, *when* they are likely to occur, and *how* the firm is able to identify and exploit those inefficiencies before others do. The resulting philosophy statement does not need to address each point in full detail nor, as discussed in Myth #3, above, does it need to be confined to one

sentence. What is important, however, is that each component be distilled to its core—just enough to present the elements of a logical argument that can be defended and articulated at greater length through conversation or a longer position statement.

- **It should be fully informed of existing knowledge.**
  A credible active management philosophy must be aware of theories and evidence that question the value of active management and be prepared to answer those objections with well-supported arguments. Two examples of such arguments are Lo's Adaptive Market Hypothesis (2004), and Grossman and Stiglitz's work on equilibrium in the supply and demand for active management services (1980), both of which acknowledge the challenges of active management and still offer hypotheses for how to add value. A robust philosophy doesn't try to squash contrary theories and evidence. Rather, it frames opportunities through this body of knowledge to show why opportunities still exist and how to identify them before others do.

- **It should be open to new knowledge.**
  A dogmatic professional philosophy is not sustainable in a field as dynamic and competitive as investment management. Active managers should welcome, not dismiss, new knowledge and ideas—especially those that present a challenge to their investment philosophy. Managers should be open to the possibility that their beliefs may need to evolve as new conditions, facts, and ideas present themselves. Even if a firm never changes its philosophy, simply remaining open to new ideas fosters a culture of continuous improvement and enriches their efforts to communicate and defend their beliefs.

CONCLUSION

Investment philosophy is about beliefs that drive decisions. A sound active management philosophy helps formulate investment strategies that could potentially outperform passive options. Beliefs help investment professionals make sense of how markets work, identify attractive opportunities, determine skills needed to exploit opportunities, and make decisions that potentially add value to clients. An investment philosophy also aids internal communication, facilitating both consensus-building and professional dissent. Varied worldviews help investment team members analyze opportunities from multiple angles—promoting risk management, and reducing confirmation bias and groupthink. In addition, an investment philosophy helps external communication, enabling managers to articulate their investment management approach to prospective clients and show current clients how decisions reflect the beliefs articulated during the marketing phase.

A robust investment philosophy must go beyond broad statements such as "markets can be inefficient." It must articulate why managers believe profit opportunities exist, when they are likely to occur, and the skill set necessary to exploit these opportunities before the competition. Sound active management philosophies are also fully aware of theories and arguments against active management. These philosophies frame arguments for active management within this body of knowledge instead of discarding views that question the value of active management. Further, a sound philosophy is open to new knowledge and revision, if that is what is called for in light of new research and accumulated experience.

The wider use of investment philosophy in active manager selection may help identify managers with real potential to outperform passive options, drive mediocre managers to improve, and eliminate managers with no hope of adding value to clients—all good things for active managers, asset owners, consultants, and in particular, the ultimate beneficiaries of funds.

We have no way of knowing whether the respondents to the CFA survey viewed their philosophy as an investment construct or a marketing tool. We hope, however, we have convinced you that a well-articulated, well-supported active management investment philosophy is a valuable asset for both investing and marketing purposes.

1. The field of philosophy has many definitions of philosophy, and even a subfield, metaphilosophy, concerned with the question "what is philosophy?" Our definition falls within the realm of what is sometimes called practical philosophy.
2. We note that intuition and experience are equally important for quantitative and fundamental managers. A quantitative approach requires intuition and experience to design algorithms, and establish portfolio construction and management guidelines. Fundamental managers rely on a combination of intuition and experience when analyzing specific investments, developing a mosaic, or estimating future cash flows.
3. These ideas were first presented in Minahan (2008) using the terms "fixed belief system," "adaptive believe system" and "proactive belief system."
4. "Unique" means one of a kind. "Distinctive" allows for the possibility that a small number of firms have a similar philosophy. We agree with the sentiment of the myth to the extent that, if three hundred small-cap managers all have the same philosophy, that philosophy is neither unique nor distinctive.
5. In modern industry usage, terms like "cues" and "signal strength" have become associated with quantitative investing. However, we would assert that fundamental investors also rely on cues and their relative signal strength when making investment judgments, although they may not think explicitly in these terms or use them to describe their approach to decision making.

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