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INSIGHTS

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THE SUCCESS EQUATION

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Throughout history, there have been numerous successful investors such as Warren Buffet, Benjamin Graham, Peter Lynch and John Bogle just to name a few. However, the source of their success, or their individual "success equation", as Michael Mauboussin calls it, is unclear if not unknown. Were they successful because they were skillful or simply doing the right thing at the right time? Answering this question and attributing success after the fact is extremely difficult as stories that get backfilled by others may suffer from cognitive biases such as self-serving bias and choice supportive bias. Therefore, the focus really should start with looking at how skill or luck relates to success.

The linkage between skill and success has always been firmly engrained throughout history. We are constantly reminded that hard work pays off and skills are important. This mantra has been repeated throughout history, so clearly skill is an important variable of the success equation. However, this is only half the story. What about the relationship between luck and success?

Malcom Gladwell famously coined the term, *demographic luck* which I define as being born at the right time *and* at the right place. If one looks at the technology giants such as Bill Gates and Steve Jobs, many of them were born in the mid-1950s. A similar case may be made for the private equity titans, such as Howard Marks and Steve Schwarzman, many of whom were born in the mid-1940s. However, being born at the right time is not enough. One also needs to be born at the right place as well. Warren Buffet, perhaps arguably the most successful investor, once said:

> "I've had it so good in this world, you know. The odds were fifty-to-one against me being born in the United States in 1930 instead of in some other country where my chances would have been way different".
>
> Schroeder (2008)

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Clearly, luck is also a very important variable of the success equation. Using these two components as the extremes, the full spectrum of skill versus luck ranges from one end of the spectrum where the world that is completely deterministic and skill being the only factor that matters to the opposite end with the world being completely random and the only variable that counts is luck. In reality, both luck and skill are critical to achieving success. However, by its very nature, luck is not only random, but also fickle and not something that can be relied upon. What about skill?

1 The limitations of past performance

In the absence of any definitive metrics of success, many investors have relied on historical performance as an indicator of skill as well as potential future performance. The natural question that arises would be, how long of a historical performance is needed for an investor to feel confident the manager has skill? If one assumes that a top quartile manager has an information ratio of 0.5, an investor will need see roughly 15 years of historical performance to be 95% confident that the investment manager has skill. However, even at this level of confidence, there still remains 5% of uncertainty. From 1991 to 2006, there was a very successful manager that outperformed the S&P 500 for 15 years straight. From this consistent performance, one may feel confident that the manager has skill. However, an investment made with the manager at the end of 2006 to 2011 would have suffered a cumulative 52% loss. Thus, the first limitation of past performance is that it requires a very long period of time to attribute past performance to skill (as opposed to luck).

The second limitation of past performance is its relevance to the future. Even if we were able to separate skill and luck and attribute past success to skills, we still need to answer the following questions: Will the future market environment be the same as the past? Would the same set of skills lead to future success? Will the people possessing the required skills be around and motivated?

2 A long-term investor's approach to skill

Despite acknowledging that both luck and skill are essential to success, luck is not obtainable while possessing relevant skill is not easily knowable. Although it may seem like nothing can be done, as a long-term investor, it is important to focus on two aspects. First, how investment decisions are made. Being a long-term investor provides the advantage of not judging investment decisions by a few short-term outcomes, given that the short-term correlation between decision quality and outcome quality is poor. Instead, the focus should be placed on having the best investment decision-making process that is built on the organization's comparative advantage, is repeatable and is protected by a solid governance structure. By focusing on things within our control and on our comparative advantages, we can mitigate the impact of random luck and increase the chance of success over the long term. Second, to better understand how to cope with skill and luck to bring the investment odds on our side, the relationship between skill and luck and why investment outcomes are uncertain needs to be further explored.

Thinking in Bets by Annie Duke provides the quintessential perspective on the underlying drivers of uncertainty. As a professional poker player, she constantly operates in an environment that involves making smart decisions when not all the facts are available, and from her perspective, the two causes of uncertainty are *incomplete information* and *factors outside our control*. Through the investment lens, when one attempts to forecast outcomes, an underlying assumption has to be made about the future return distribution. In this context, *incomplete information* would be not knowing exactly what the future return distribution would look like. *Factors*

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outside our control would then refer to knowing the exact distribution but with an actual outcome that is randomly drawn from the distribution.

From my perspective, these two drivers of uncertainty correspond to the two ingredients of success—skill and luck. Skill is our ability to change the shape of the future return distribution, whereas luck is drawing a favorable outcome from the future return distribution. As an investor, to get the odds on our side and to increase the chance of success in an uncertain world, there are things we can do to improve our skills as well as things we can do to mitigate the impact of bad luck. From the skills perspective, I believe that there are three key aspects that can help improve the odds in our favor that are well suited for a large organization such as CalPERS.

First, improving investment capabilities in strategic and tactical asset allocation since research has shown that strategic asset allocation explains the majority of the return variations and tactical asset allocation allows us to exploit temporary market dislocations. In addition, as a large asset owner, CalPERS is in a relatively unique position to access the less efficient private asset markets.

Second, investing requires focus on the right activities that includes not being distracted by non-investment activities and focusing on a total fund approach where resource and risk allocation are proportional to potential contribution to the total fund. Broadly speaking, we can put investment activities at a public pension fund into two categories: things we must do (e.g., implementing a beta portfolio to capture long-term risk premia) and things we choose to do (e.g., active risk taking away from beta). Staying focused means that for the things we must do, let us do well; and for things we choose to do, let us choose well. That is, let us choose the right things and then do things right.

Lastly, the organization needs to focus on its comparative advantages (such as our mission, size, brand name and long-term horizon). Focusing on these three aspects will improve our investment skills, which then helps reduce the uncertainty and shapes the future return distribution to our favor.

3 A long-term investor's approach to luck

Acquiring superior investing skills does not, however, change the fact that investment outcomes are random draws from a distribution curve. This luck aspect of investing has been attributed by some to be the only aspect that matters because it is a "winner-take-all" world in investments, and there is not much an investor can do. Although this may be true for asset managers because people tend to chase short-term winners and redeem from managers that have not recently been "lucky," CalPERS is in a unique position because it is an asset owner. As long as we avoid redeeming from ourselves, we have the ability to weather the storm.

First, the organization needs to focus on the long-term and not succumb to short-term outcome bias. Second, when luck is not on our side, we need to "keep calm and carry on" and trust in the sound investment decisions that were made. The advantage of being a long-term investor is to not judge investment decisions by short-term outcomes, but this requires a solid decision-making process built on the organization's comparative advantage and an appropriate governance to support long-term thinking. As 19th century American author Bret Harte once said that "the only sure thing about luck is that it will change". That is, luck is fickle and it is highly improbable to be subjected to bad luck all the time. The challenge is surviving the periods of bad luck. Having a long-term focus alone is not enough as one needs to survive the short-term bad luck first before exploiting the benefits of having a long-term investment horizon.

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("In the long-run we are all dead and we need to make sure the short-term does not kill us first").

How do we ensure that we can survive the short-term market volatility? We need to develop a comprehensive and pro-active liquidity management framework. Liquidity management is critical for an organization like CalPERS that has beneficiaries dependent on receiving payment each month. In addition to the cash on hand to pay for benefits, short-term market volatility can impact the liquidity profile of the fund in a number of other ways. For example, market volatility can affect the trading liquidity of the assets in the portfolio that consequently impairs our ability to generate liquidity when needed. Market volatility can also impact the balance-sheet liquidity of the fund by triggering margin calls. Can we maintain the desired long-term risk exposure through the volatility? Can we take advantage of market dislocations that usually happens during a market crisis? We need to manage liquidity in a more intelligent way because too much liquidity may be harmful but too little liquidity can be deadly. What is the optimal amount of liquidity? To answer this question, we need to identify all potential uses and sources of liquidity while recognizing that not all uses of liquidity are equal in terms of negotiability and predictability and not all the sources are equal in terms of reliability and costs. Ultimately, a comprehensive liquidity management framework enables CalPERS avoid redeeming from itself and mitigate the impact of bad luck. More details on my perspective of a liquidity management framework will be further explored in a follow-up piece.

Although surviving short-term market volatility is a prerequisite, a second component for long-term success is having a comprehensive crisis management plan to mitigate the impact of bad luck.

Having a long-term focus will reduce the impact of random luck on decisions because the longer the investment horizon, the less the impact random effects will have. This is especially true when we have an investment decision-making process that is built on our comparative advantages. If we can overcome short-term bad luck and stay focused on our long-term investment horizon, we can benefit from the power of compounding. Albert Einstein once said that the most powerful force in the universe is compound interest. If we think our comparative advantage as the interest we are compounding, the liquidity management framework ensures we weather short-term volatility while our long-term focus allows us to thrive through the power of compounding of our comparative advantages.

The success equation that I envision for CalPERS is twofold. First, build a strong investment process that hones the organization's investment capability, focuses its capability on investment activities at the total fund level and harnesses its comparative advantages. These three aspects will incrementally improve the odds of the return distribution in our favor. Second, with a comprehensive liquidity management framework and the power of a long investment horizon, allow these benefits to grow and compound over time. Improving our skills re-shapes future return distribution to our favor while focusing on the right activities and adopting a long-term approach mitigate the impact of luck.

Although this success equation that I envision does not guarantee success, in the uncertain world of investments, I believe this framework does improve CalPERS' chances of achieving success so long as we "keep calm and carry on."

Reference

Schroeder, A. (2008). *The Snowball: Warren Buffett and the Business of Life*, New York: Bantam Books, Print.

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