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First State Investments

Global Fixed Income
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THE POWER OF INDEPENDENT THOUGHT

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In life we are all too familiar with the concept of not putting all your eggs in one basket, for fear of the basket falling and all the eggs being broken. This concept is often translated into investment portfolios and coined "diversification" – investing in a range of different assets that are deemed to be uncorrelated or lowly correlated. Hence when one asset falls the others hold up the portfolio and protect investment returns – effectively putting your eggs in a range of different baskets. But what if the same person is carrying all of the baskets? If that person falls are your eggs sufficiently protected? We discuss the importance of independent thought as an additional means of diversification – ensuring that your eggs are suitably cared for by a range of independent thinkers and decision makers, hence reducing the likelihood of one bad decision breaking all your eggs.

The "father of value investing" Benjamin Graham had it right when he wrote: "the stock market investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right." Back in 1949, Mr. Graham saw the power in thinking for yourself. Today, most investment firms would probably agree and claim to manage their portfolios accordingly. Yet on closer inspection, you might find that most firms incorporate decision making practices that actually remove independence, to some extent, from the decision making process. This can be via relying on the decision making skill of a single person e.g. the Portfolio Manager or constraining views to those that align with a 'house view'.

These common decision making practices can act to remove independence. Terms like group-decision-making, approvals, consistency with house view – are, more than likely, code-words for independence killers. Of course some investment teams may be able to foster an environment supportive of independent thought, but in most cases, the odds aren't stacked in favor of free thinking.

How one bad egg can spoil an omelet

Simply, decision making involving groups of thinkers or team meetings (and especially the combination of both) can quickly strangle independent thought. To begin with, the personalities involved can serve to extinguish independent ideas and voices. Dominant personalities often lead to dominant views as they frequently rule the discussion, monopolizing time and bullying others towards their line of thinking. Also, input from less vocal team members is often lost, along with the value of their independent thought contributions. But it's not just the egotistical, ear-bashers that can hamper independent thought, both organizational structure and the decision making process are also key culprits.

Organizational structure is a common deterrent to those providing independent thought. Again, most investment professionals have witnessed (if not taken part in) a general reluctance to disagree with a superior, or even a peer – disagreement is hard work, especially when it's with your boss. Conforming is innate in most workplaces, as often the "alternative" view is less welcomed or met with enough resistance that it finally wears the independent thinker down until they reluctantly agree to the common view.

In addition, a group's decision making structure/process can stymie independent thought. If the decision making system requires agreement or consensus, groups commonly compromise in the pursuit of consensus, relenting on their independently held views. The pressure to make a decision often demotes the aim of independent thought, especially in the time-poor world we live in today.

Not only is independent thought quashed in these environments, often investment decisions are slower to be implemented as they are reliant on the timing of the team meetings or the distribution of the key investors thoughts. Rarely is this done in real time, hence resulting in a loss of opportunity to implement positions in line with the rationale and the market conditions supporting these.

So how do you foster independent thinking? And as an investor how do you identify independent thinking? Indeed, it's difficult to create and maintain a truly "free thinking environment" and even harder for investors to appreciate the uniqueness of the few fund managers who achieve this. We can best answer both of these concerns using our investment process as the basis. We believe our process relies on independent thought, and is fully unconstrained from any analyst's authority regarding decision making. We highlight below the elements of our investment approach that create independent thought.

Success is pivotal on creating an environment of independent thought

This can be achieved by:

i. Analysts are assigned to specific alpha sources and register their views on a transparent proprietary opinion management system that logs, conveys, and measures these views.

ii. Analysts are free to select their own views and are free to change views when they see fit, without any vetting or approval required.

iii. We have multiple people following specific return sources, but each analyst enters and maintains their views as they see fit and is measured independently for their effectiveness.

iv. Portfolio management decisions are independent from alpha source generation. So while PMs implement alpha sources in portfolios based on risk limits, they are not making the calls on the direction in which to implement a call (long/short, steeper/flatter) hence removing potential for additional bias from the portfolio construction process.

Our decision making doesn't rely on group mentality and it doesn't rely on formal meetings. While there is plenty of opportunity to bounce investment ideas off of peers and access research and views on alpha sources from other analysts, our process ultimately relies on individuals and their independent skill as decision makers.

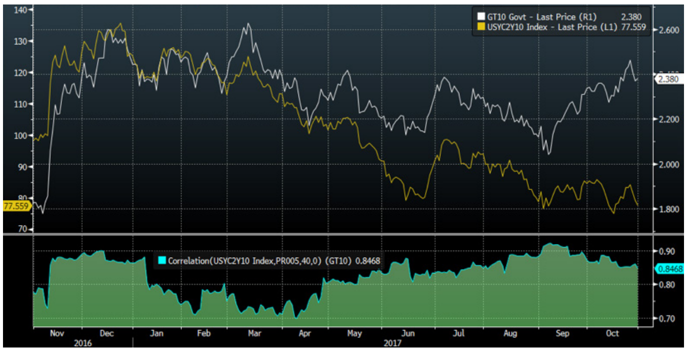
Because we have instituted this form of decision making, and associated measurement with each individual's contribution, we gain all of the following:

- It allows us to measure the skill that drives our portfolio returns, and isolate where that skill resides.
- It allows us to manage our skill, to isolate areas that need improvement and causes of any deficiency.
- It allows us to use realistic skill expectations in our product designs.
- It allows us to more precisely reward those that contribute positively to our portfolios.

These are the obvious benefits of unconstrained and independent decision making. However, there is one final benefit to a decision making process that relies on unconstrained, independent thought.

A decision making system that relies on independence of thought can remove the tendency of teams (or PMs) to amplify position correlation. To see this, assume that we have two return sources and two competing decision making processes, one that uses a PM as the decision maker and one that uses two independent analysts. For the PM, he or she makes decisions regarding both return sources and for the two individuals each is assigned one of the return sources. Finally, assume the return sources are highly correlated, perhaps as much as the two return sources below (Chart 1).

Chart 1: 10Y US Treasuries correlation to the 2s/10s curve



Source: Bloomberg

If the PM recognizes that the two alpha sources are highly correlated, he/she will most likely either invest one alpha source on behalf of both sources or act on both at roughly the same time. This seems completely reasonable, as they are highly correlated and in effect, duplicate return sources. Thus the natural correlation between the two return sources is preserved, and invested as such within the portfolio.

But two individuals, acting independently, would not likely invest these return sources in exactly the same way – when they put the signal on and for how long they hold it. This is the approach that we take at First State Investments, investing the two return sources below by giving individual analysts these separate responsibilities. Their actual investment positions are represented in charts 2 and 3 below.

The blue lines in the charts represent each analyst's views and our active positions over time. When judged against the right side horizontal axis, anything that is non-zero reflects a long or short active risk in the associated return source. The blue line depicts long or short positioning, where 0 is neutral, +100 is the long side limit, and -100 is the short side limit and the yellow line represents the price of the return source.

Chart 2: Active US yield curve positioning

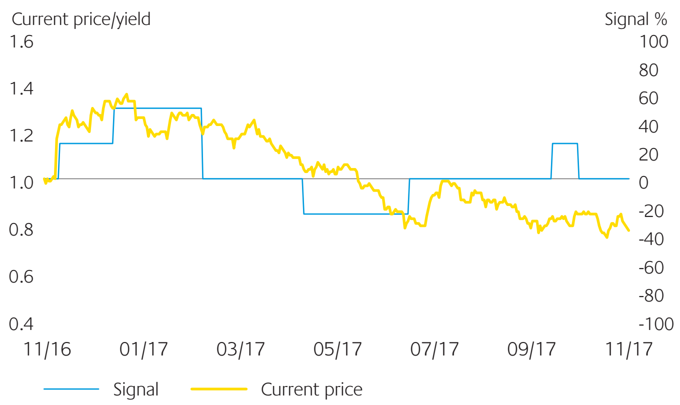
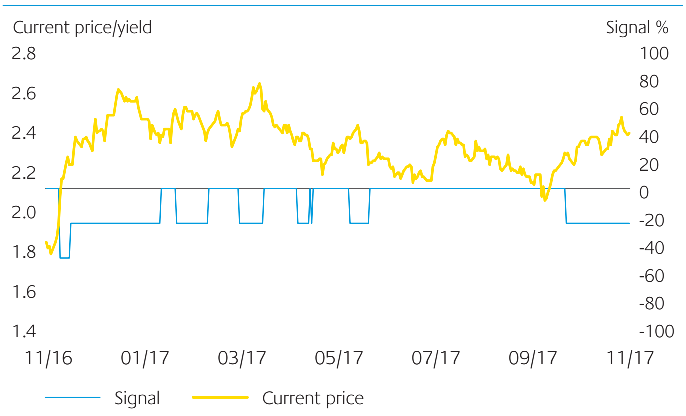


Chart 3: Active US duration positioning



Source: Investment Opinion Network (ION), First State Investments

A few things should stand out:

i. While the two pricing series are highly correlated (as seen in chart 1), the two active positions are not. The yield curve position is both long and short over the period considered, whereas the rate position is only short.

ii. The holding periods for the active positions are very different, with the curve position persisting for longer periods, whereas the rates position is typically extinguished quickly and actively re-entered.

iii. The entry and exit points are very different.

Of course there is always the possibility that the two independent analysts could invest in a manner that removes their independence, but there are ways to control for this (measure them, and hold them accountable to their measured effectiveness, for example). And there are times when the views of each conflict, one canceling the other out. But acting in a truly independent manner tends to minimize these problems, and again, good risk management can act to control these infrequent occurrences.

It's clear that independent thought has powerful benefits for an investment decision making process.

So, while the sources of returns can be highly correlated, the active positions that result from our individual and independent signaling process are typically not highly correlated. Further, this independence also creates diversity in holding periods (something others have called horizon diversification) and entry and exit points.

Could you reach the same outcome in a group decision making structure, where consensus was relied upon to take active positions? Perhaps, but again the odds are stacked against this. Group decision making would likely have resulted in adding and reducing positions consistent with the meeting schedule and viewing the two alpha sources as one: after all they are highly correlated, so why consider them unique? It's likely that this decision making process would have invested the two as though they were the same; invest one or the other, or double the exposure to the one deemed most attractive. This is a prime example of two eggs in seemingly different baskets being treated in exactly the same manner – and if one breaks then there's nothing stopping the other from breaking too.

Some would counter this approach by saying that they don't mind having all their eggs in one basket because they carefully watch the basket! Or that diversification can become too much of a good thing. However, markets have a way of humbling even the most seasoned and successful investors. Groupthink, overconfidence, confirmation bias, and proving oneself right, are all extremely dangerous behavioral traits when it comes to investing. While all investors are susceptible to these biases, we seek to limit these through our investment process, which segregates decision making across alpha sources and promotes true diversification embedded in client portfolios. In short, we believe in the power of independent thought because sometimes you will be wrong and this should not jeopardize the ability to deliver on your objectives.

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