PAVILION

Pavilion Advisory Group™

Q1 2014

INSIGHTS

OPENING NOTES

FLEXIBILITY CAN BE FOUND IN OUTSOURCING

BY J. KEITH MOTE JR., CFA, MANAGING DIRECTOR OF PAVILION ADVISORY GROUP

I am presenting at an upcoming conference soon on the subject of discretionary or implemented consulting. The concept, also often referred to as outsourced CIO, is gaining significant traction, but I've found many institutional investors are confused by exactly what the terms mean. Further confusion has been created by the variety of different solutions being offered in the marketplace.

In a nutshell, the terms "Discretionary Consulting", "Implemented Consulting", and "Outsourced CIO" all refer to delegating decision-making authority to a third party. The reasons many organizations are looking to delegate authority are sound. Some investment committees are realizing they do not or cannot meet often enough to (i) provide the oversight necessary to appropriately position their portfolios in a high-volatility environment and (ii) to take advantage of market opportunities. In addition, staff members are facing increasing demands on their time and budgets to manage operations.

As organizations evaluate whether they wish to delegate decision-making authority to their consultants or other providers, they also need to think about how much authority they wish to hand off.

The question of "how much" is an important one. When one hears the term "outsourced CIO", it may appear to suggest a 100 per cent shift in decision-making authority to an external party. This is common in private wealth management, but typically institutional investors either have hired an investment consultant to advise a Committee or Board on how to invest and work with staff to implement, or they have built in-house teams of investment professionals to manage their investment portfolios.

At Pavilion, we view implemented consulting as a strategy that "brings to life" the advice we provide to clients. Our discretionary model leverages the non-discretionary services we have practiced for 30 years. In this model, we act as an extension of staff providing additional resources to meet today's challenges and leading to a governance structure with clear procedures that identify management responsibility, accountability and deliverables.

Pension plans, endowments and foundations can delegate to us such responsibilities as the authority to retain and terminate managers, implement changes in asset allocation strategy based on the client's defined parameters or actively manage certain assets in the portfolio. The amount of discretion is determined by the client based on available resources, governance requirements, etc. The benefits of having a single, focused decision-maker handling these responsibilities include timely investment implementation, more effective use of Investment Committee time, and increased staff efficiency.

This is not an all or nothing approach; there is a great deal of flexibility in what can be outsourced. It's important to choose the right model for your organization.

Keith

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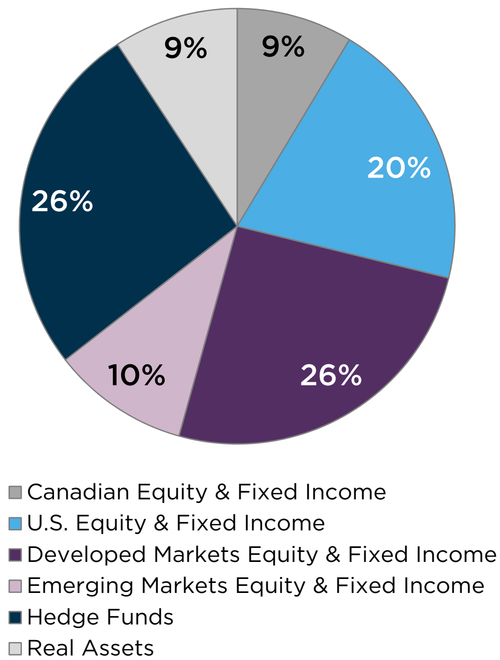
PAVILION RESEARCH ACTIVITY: 2013 RECAP

Investment Manager Meetings

Pavilion's dedicated manager research team, through an intensive due diligence process, continuously assesses numerous qualitative, performance and risk characteristics of investment management firms located around the world. Priding itself on hands-on research, Pavilion's analyst team conducted 1035 research meetings with investment managers in 2013. Over 330 of these meetings were held on-site in the managers' offices.

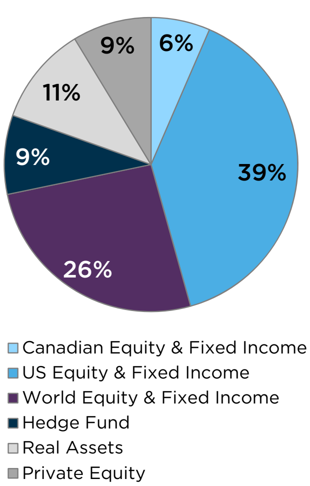
This chart illustrate the breakdown of most frequently discussed mandates during these meetings.



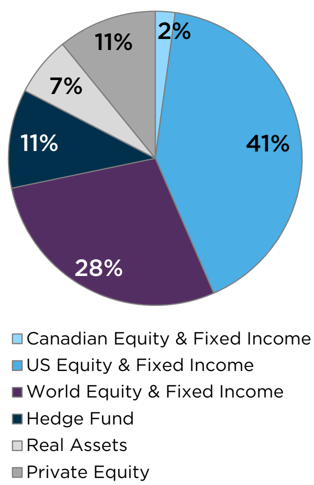
Research projects conducted for our clients in 2013 (U.S. and Canada)

In 2013, over 100 manager research projects were initiated for our clients totaling over $6 billion in assets. The pie charts below represent the mandates that were of most interest to the different client categories.

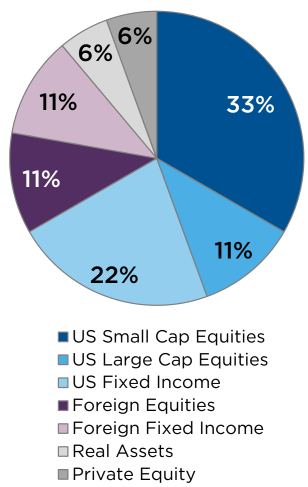
Pension Plans



Foundations & Endowments



Healthcare



INSIGHTS

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NEW AGE FOR TACTICAL ASSET ALLOCATION

By Tom Dodd, CFA, CAIA, FSA, Senior Vice President, Consulting North America

There have been many changes across the institutional investment landscape post-financial crisis, with one of the more intriguing being the willingness of institutional investors to consider and implement tactical asset allocation strategies. Since the development of current institutional investment governance practices, which started evolving in the mid-1970s, allocating assets tactically has been anathema to investors. However, since 2008 we have seen a subtle, but noticeable, shift in the attitudes of investors towards tactical approaches.

This paper will (1) define tactical asset allocation strategies, (2) examine asset allocation practices pre-2008, (3) discuss the factors that are leading investors to consider a change and (4) show how to implement tactical strategies.

What is tactical asset allocation?

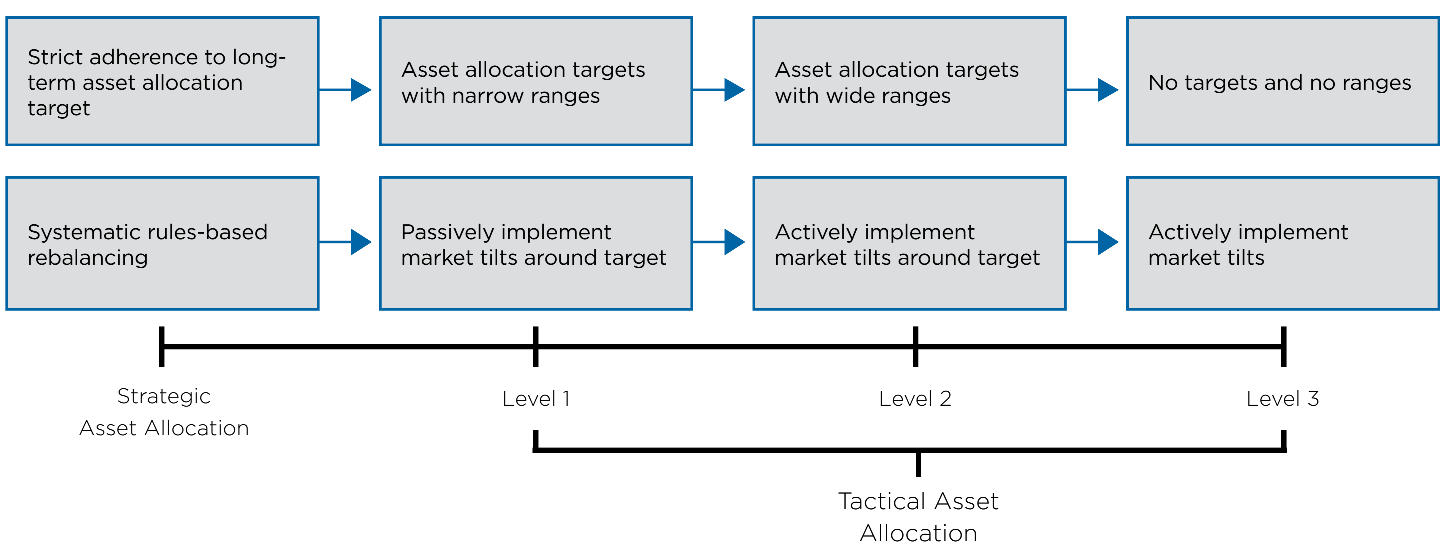
No one investor has the same definition of tactical asset allocation. In order to provide clarity, perhaps we can juxtapose tactical asset allocation against what it is not, a method called strategic asset allocation. Strategic asset allocation develops a long-term asset allocation target (how these targets are developed is beyond the scope of this paper) and assets are rebalanced systematically to the target over time. Two words in that definition are critical and differentiate strategic from tactical asset allocation: long-term and systematically. By long-term we mean that the targets are intended to be effective for at least three- to five years. By systematic, we mean a rebalancing technique that is rules-based and implemented consistently regardless of market conditions.

There are many gradations of tactical asset allocation, starting with an approach that is only slightly different from strategic asset allocation and moving along a continuum that ends with an approach most investors would associate with market timing.

Level 1

With Level 1 tactical asset allocation, the investor develops a long-term asset allocation target, similar to strategic asset allocation. The differentiation between Level 1 and strategic asset allocation is that there is no systematic rebalancing. In most cases, each asset class within the portfolio has an asset allocation range with an associated target. These ranges may be narrow, for example plus or minus five percentage points from the target. The investor usually develops an opinion about which asset classes are over or undervalued. Asset class over or underweights, however, mainly occur as a result of asset appreciation or depreciation relative to other asset classes. These asset class over or underweights may be enhanced as a result of cash flow decisions on the part of the investor. For example, if the investor believes that large-cap equities are undervalued, contributions to the portfolio may to directed to large-cap equities. A distinguishing characteristic of Level 1 is that the tactical bets are implemented more passively than Levels 2 and 3. Rebalancing occurs when the investor has a change of opinion about asset class valuation or when an asset class

Asset Allocation: Strategic or tactical?



allocation is close to its corresponding range boundaries. The critical distinction between Level 1 tactical and strategic asset allocation is that the investor has an opinion about the market and that opinion influences the asset class weights in the portfolio. However, in a Level 1 situation, the asset class over or underweights are never substantial and are constrained by narrow asset class allocation ranges.

Level 2

Level 2 tactical asset allocation is similar to Level 1 with two exceptions: the asset allocation ranges tend to be wider than Level 1, say plus or minus 10 percentage points or greater, and asset class over or underweights are enhanced by active rebalancing decisions made by the investor. For example, if the investor believes that large cap equity is undervalued and small-cap equity is overvalued, the investor will move assets from small-cap to large-cap. In Level 1, the over or underweights were attained in a more passive approach. As with Level 1, rebalancing occurs when the investor has a change of opinion about the market or when the asset class allocations are close to their corresponding range boundaries.

Level 3

Level 3 tactical asset allocation is the most unconstrained of the three levels. Asset class targets may not exist and asset class ranges may be very broad. The investor has a strong opinion regarding relative asset class valuations, and asset class weights are changed only when the investor has a change of opinion regarding the market. Since there are no long-term asset allocation targets, rebalancing does not occur. Level 3 tactical asset allocation is closely associated with the much maligned phrase: market timing.

In an attempt to provide a definition, I have conveniently created these three tactical asset allocation levels. In practice, investors implement various forms of tactical asset allocation that fall along a continuum highlighted by increasing investor activism and less willingness to be constrained by asset allocation targets.

Asset Allocation Practices Pre-2008

Since the mid-1970s, when current institutional governance practices started evolving, most institutional investors have used the strategic asset allocation approach or its close relative, the Level 1 tactical asset allocation approach. There are several reasons why investors migrated in this direction.

Firstly, there was the belief that tactical asset allocation techniques didn't work. Quite simply, investors did not believe it was possible to successfully and consistently implement market timing calls. Investors didn't distinguish between the various levels of tactical asset allocation...all levels were associated with market timing.

Secondly, tactical asset allocation required somebody to have an opinion on the market. Investors were uncertain of who to rely on for that opinion and how to implement that opinion.

Faced with these roadblocks, investors found it easier to use a strategic asset allocation approach or the Level 1 tactical approach. Many investors adopted the Level 1 approach because they had an opinion on the market and Level 1 allowed them to express that opinion in a stealth fashion as there were no active asset allocation bets.

Why Investors are Reconsidering Tactical Approaches?

Coming out of the 2008 financial crisis, many investors started to reconsider their long-held opposition to tactical asset allocation. This shift in opinion came about as investors observed the futility of rebalancing into a rapidly declining market. The strategic asset allocation approach did exactly that. As equities declined in value, the strategic approach required investors to increase the equity allocation back to target, only to see this new allocation disappear as markets continued to decline.

Investors realized that a rules-based rebalancing technique was inappropriate in both rapidly declining markets and volatile markets. Perhaps it was possible to take an opinion on the market and effectively incorporate that opinion into an asset allocation strategy.

One manifestation of this shift in thinking has been the growing popularity of tactical asset allocation funds post-2008. Although few investors retain a TAA manager for their entire portfolio, there is a growing cohort that retain a TAA manager for a "sleeve" of their portfolio.

In addition, investors have come to distinguish between market timing and less extreme forms of tactical asset allocation, such as Level 2.

However, now that more investors have come to accept the efficacy of tactical approaches, there still remains the significant governance hurdle of who develops an opinion on the market and how to implement that opinion.

How to Implement a Tactical Strategy

In an institutional asset management environment, there are four groups that are positioned to develop and implement a tactical allocation strategy: investment committee, management (usually the CFO, CIO or Treasurer), investment consultant or investment manager.

In deciding which group is best positioned to develop and implement a tactical strategy, three factors should be considered:

- **Resources:** the group has the resources to develop a broad view on the market encompassing all markets including traditional equities, traditional fixed income, and alternatives.
- **Experience:** the group has been developing this market view for an extended period of time.
- **Performance:** the group has a track record of successfully implementing this view in a tactical framework.

Based on these three factors, it would seem that investment consultants or some investment managers, those that have tactical asset allocation experience, would be best suited to develop and implement a tactical strategy. Most investors, and by extension I mean investment committees or management, do not have the dedicated resources to consistently develop this broad market view.

Once the group has been selected, the investor needs to make one final decision. Prior to implementation, does the tactical strategy need to be reviewed or authorized by the investor? Another way to state this, does the group that develops and implements the tactical strategy have investment discretion? If the tactical strategy does need review or authorization, who performs the review or grants authorization on behalf of the investor?

Success of tactical strategies depends to some degree on timing. The more unconstrained the strategy, moving along that tactical continuum that we discussed previously, the more important becomes timing. A review or authorization process would potentially slow down the implementation of the tactical strategy. Review or authorization by the investment committee presents some challenges. Committees don't meet frequently enough and would not feel they had enough knowledge to perform an adequate review. If a review or authorization was built into the process, it may make sense to have one person with that authority. The person best positioned for that would be the CIO or the equivalent. However, as long as the tactical strategy and the corresponding written guidelines were clearly stated at the onset of the strategy, the discretionary approach may be the most effective. What is critical in the discretionary mode is effective communication between the consultant or investment manager and the investor. The consultant or manager would state their view on the market and coincident with all decisions, communicate those decisions to the investor.

Conclusion

More investors are considering and implementing tactical asset allocation strategies since the financial crisis. Investment consultants and some investment managers may be best positioned to implement those strategies. Since nimbleness and timing can be critical components to the success of a tactical strategy, reviewing governance practices to assure an efficient committee decision-making process, or granting the consultant or manager investment discretion may improve effectiveness.

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OUT AND ABOUT

Susan McDermott, Chief Investment Officer, Institutional Advisory, and **Kerry Elsass**, Consultant, will be attending the Commonfund Forum 2014 in Hollywood, FL March 8.

Rich Marra, Senior Consultant, will co-lead a discussion group at Institutional Investor's Corporate Funds Roundtable March 11 in Washington, DC.

Eric Fontaine, Senior Consultant, will be attending "Dialogue with our Leaders", a CFA Montreal Chapter event April 10. Speakers include representatives from the Université de Sherbrooke, Concordia University, McGill University and the Université de Montréal.

Pavilion is co-hosting the Hospital & Healthcare Services Forum organized by IMI April 27-29 in Chicago. **Alyssa Cheatham,** Senior Consultant, will moderate a panel discussion on equities; **Rich Marra,** Senior Consultant, will lead a panel discussion on the outlook for not-for-profit healthcare systems; and **Tom Dodd**, Senior Vice President, Consulting North America, will moderate a discussion on customized solutions.

THE CHANGING FACE OF HEDGE FUND INVESTING[1]

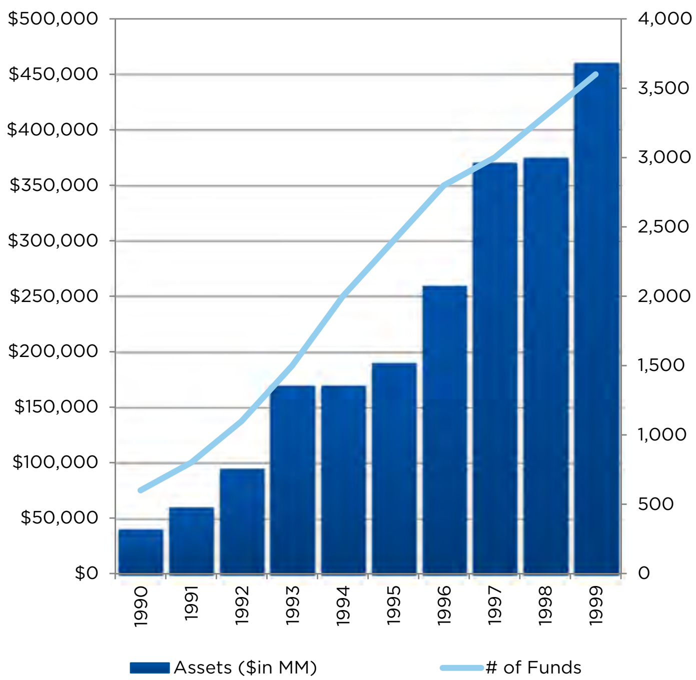
By Alex Da Costa, Director, Hedge Fund Research & Consulting

The objective of this article is to show how the hedge fund industry has grown from a small, opaque, niche sector directed towards high net worth investors into a large, transparent, and institutional-quality fund management business. It also describes how smaller investors are no longer limited to investing in hedge funds through fund of funds and how more of them are choosing to invest directly.

A brief history

Despite having its start as early as 1949 (see side bar), the hedge fund industry remained largely a niche sector until the 1990s when real growth emerged. (See Chart 1)

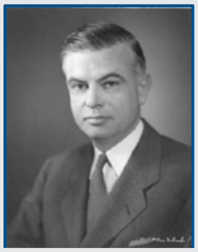
Chart 1: Growth of the hedge fund industry during the 1990s



In 1990, the total size of the hedge fund industry was $38 billion, with fewer than 500 funds. Over the next 10 years, AUM grew more than 10 times to just over $450 billion. The number of funds grew dramatically to over 3,500.

The investor base during this period was largely comprised of high-net-worth individuals and family offices, and the fund of hedge fund business began its development to service this growing demand from private investors. Fees were high, transparency was poor and operational infrastructure was limited.

Who is credited with starting the first hedge fund?



In 1949, Alfred Jones wanted to find a way of investing where the value of his portfolio would be driven by the quality of his stock picking and not by the ups and downs of the broad market. He embraced the concepts of leverage and shorting, using these to construct a market-neutral portfolio where he was short by the same dollar amount as he was long. Over the next two decades Jones's hedge fund enjoyed strong success, significantly outperforming long only funds and other market benchmarks. His success began to get the attention from some in the investment world and a number of launches ensued, including the legendary George Soros in 1969.

Another important feature of the 1990's was that new or previously niche strategies began to gain traction. This included more quantitative strategies that were able to take advantage of greater computing power and new financial instruments. With the development of these more complex strategies came more sophisticated hedge fund managers.

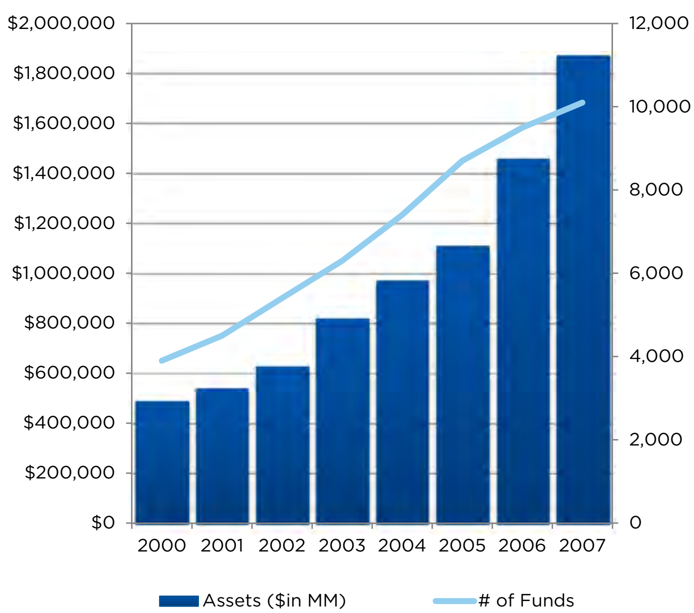
At the end of the decade, some fund of hedge funds were delivering annualized returns of over 15% with a volatility of just over 6% – numbers most investors would be thrilled with today. However, the irony is that, back in 1999, not all investors were satisfied with 15% net returns as dot.com fever had taken hold. As the bubble popped in early 2000 and the stock market crashed, fund of hedge fund returns once again started to look very attractive, particularly on a risk-adjusted basis.

1 - In January, Mr. Da Costa was a session presenter at the 11th Annual Foundation, Endowment and Not for Profit Investment Summit held in Toronto, Canada. This article summarizes a portion of his presentation.

Hedge funds performed relatively well during the dot.com crash (See Table 1). The HFRI Equity Hedge Index suffered a maximum drawdown of only 10.3% while the S&P 500 was down almost 45% and the NASDAQ was down a whopping 80%. Looking at the longer term, hedge funds as a group delivered equity-like returns term but with significantly lower volatility. For example the HFRI Fund Weighted Composite delivered returns of 14.5% with a volatility of 7.3% versus the S&P 500, which had delivered a return of only 9.7% but with more than double the volatility.

Heading into the new millennium, the hedge fund industry saw its next important growth phase. (See Chart 2)

Chart 2: Growth of the hedge fund industry during the 2000s



Asset growth went from under $500 billion in 2000 to over $1.8 trillion by 2007. During the same period, the number of funds grew from 3,500 to over 11,000. This asset growth was driven in part by institutions becoming increasingly interested in the space. As many were unfamiliar with hedge funds, they chose to invest via fund of hedge funds, fueling rapid growth of that sector. This period marked the beginning of the institutionalization of the hedge fund industry.

The next major milestone in the industry came with the market crash of 2008. The severity of the crash had knock-on effects that very few people foresaw. The losses across some parts of the hedge fund industry were beyond what most had expected and exposed serious flaws in some business models. Many funds suffered liquidity "mis-matches" and were unable to pay out redemptions promptly.

Performance-wise the main hedge fund indices were down around 20%. Many fund of hedge funds suffered similar losses as correlations spiked and few strategies other than macro and systematic provided any diversification. However these losses, despite being large, were once again less than half of what long only equity investors experienced.

Sowing the seeds of change

The global financial crisis actually sowed the seeds for the next major evolution of the hedge fund industry. Weaker managers shut down while the stronger ones survived and built more robust businesses. Institutional investors once again saw how hedge funds performed relative to other investments. These investors started increasing their allocations to hedge funds as a way of reducing portfolio volatility without giving up meaningful upside. As large institutions became the dominant source of new capital, they were able to effect significant changes into how hedge

Table 1: Hedge fund returns vs. market benchmarks 1990-2002)

	Return	Standard Deviation	Return/ Risk	Maximum Drawdown	Peak	Valley	Maximum Drawdown Dot.Com Crash Mar-00 - Sep-02
HFRI Fund Weighted Composite Index	14.50%	7.30%	2	-11.40%	Apr-98	Aug-98	-6.40%
HFRI Equity Hedge (Total) Index	18.20%	9.30%	2	-10.30%	Aug-00	2-Sep	-10.30%
HFRI EH: Equity Market Neutral Index	10.30%	3.30%	3.1	-2.70%	Jan-99	Apr-99	-1.60%
HFRI Event-Driven (Total) Index	14.20%	6.80%	2.1	-10.80%	Apr-98	Sep-98	-9.30%
HFRI ED: Distressed/Restructuring Index	14.30%	6.30%	2.3	-12.80%	Jun-98	Oct-98	-4.00%
HFRI Macro (Total) Index	16.80%	8.70%	1.9	-10.70%	Jan-94	Apr-94	-7.30%
HFRI Relative Value (Total) Index	13.10%	3.80%	3.4	-6.60%	Jun-98	Oct-98	-0.50%
HFRI RV: Multi-Strategy Index	10.90%	3.60%	3	-8.30%	May-98	Oct-98	-2.00%
S&P 500	9.70%	15.20%	0.6	-44.70%	Aug-00	2-Sep	-44.70%
MSCI AC World Index	4.50%	15.10%	0.3	-46.30%	Mar-00	2-Sep	-46.30%
NASDAQ 100 Stock Index	9.10%	27.80%	0.3	-80.70%	Mar-00	2-Sep	-80.70%
Barclays Aggregate	7.70%	5.00%	1.5	-7.40%	Jan-94	Jun-94	-2.00%

funds conduct their business. Hedge funds were forced to lower fees, and improve transparency and governance particularly with respect to areas such as pricing.

Fees

At the hedge fund level, fees for top managers have been pretty sticky at 2% management and 20% performance fee. But for the average fund, management fees have come down to about 1.6% management and 18% for performance. Where fees have come down dramatically is at the fund of fund level. Back in the 1990s fund of fund fees were a fairly standard at 1.5% management and 15% performance. That has now come down to an average of 1% management with no performance fee. The largest investors will see fees even lower than that.

Transparency

Managers have improved the quality of their reporting, with many providing investors with the full portfolio (albeit usually on a lagged basis). Most managers are willing to review the live portfolio with an investor during an onsite meeting; if they are not, an investor should question why not. Not only has transparency through the managers themselves improved tremendously, but there are now other ways investors can gain heightened visibility. Third-party providers like Risk Metrics are able to provide investors with independent risk and transparency reporting. This is a powerful tool that some larger investors and consultants have implemented.

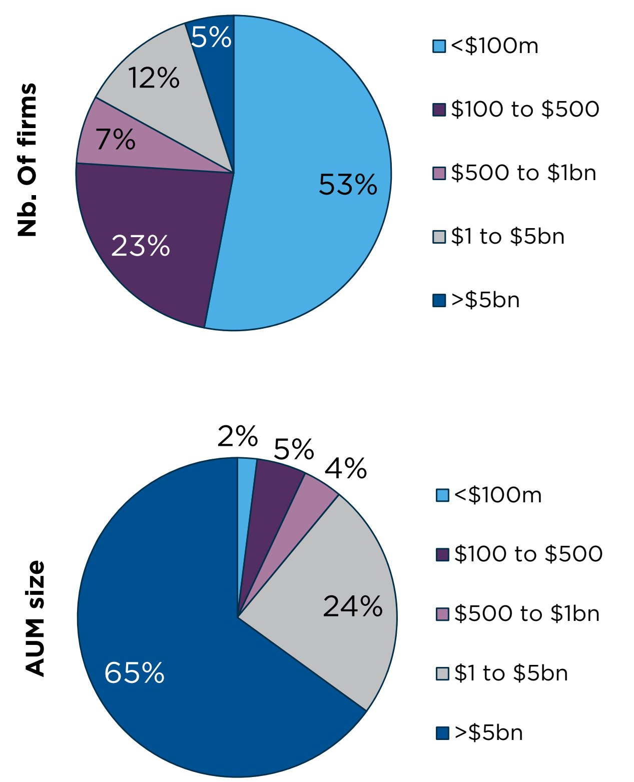
Governance

Several industry scandals have brought poor governance practices to the forefront of investors' attention and have forced changes across even the smallest managers. Hedge funds are now almost all priced independently by third-party administrators using independent pricing sources. Boards of directors are now typically more independent and play a more active role in overseeing the fund's management.

Big getting bigger

Large, institutional-quality hedge funds continue to attract the lion's share of industry assets. From Chart 3, we see that 17% of managers with AUM over $1billion control nearly 85% of total industry assets. What's more, only 5% of managers have AUM over $5 billion and they alone control more than 65% of total industry assets. This raises concerns that some managers are becoming asset gatherers. However, some of these large funds have become extremely sophisticated and are helping to redefine the role hedge funds play in the capital markets. These large hedge funds are using their investment capital to engage in traditional investment banking activities such as business financing, and market making. Hedge funds are gaining an increasing share of these activities as regulatory changes such as the Volker rule force banks to reduce their proprietary activity.

Chart 3: Largest managers attract the most assets



Risk management

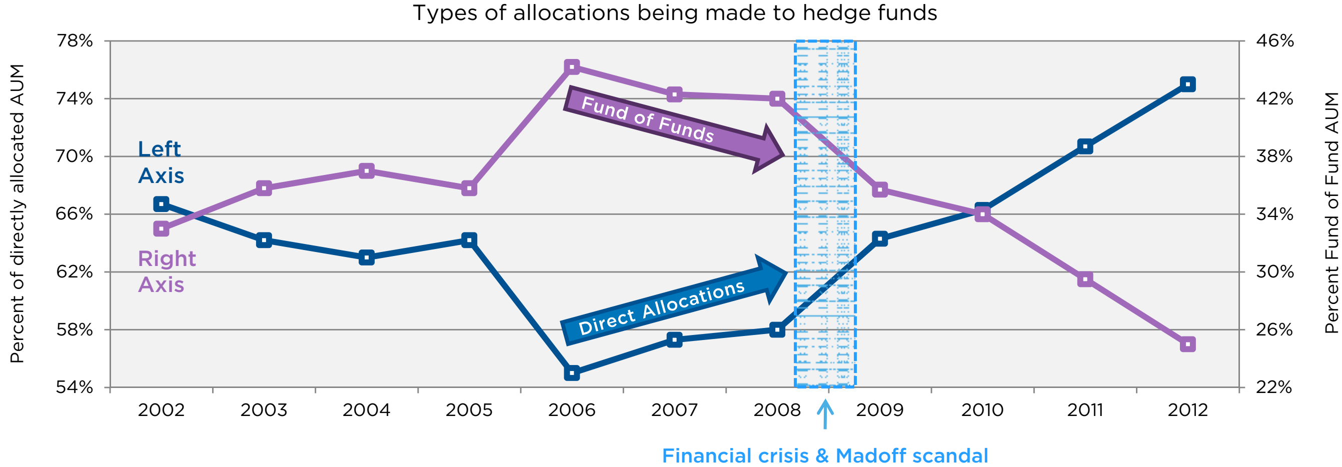
Another change, which in part has been driven by the institutionalization of the business, is a greater focus on risk management. Institutions have a different risk appetite compared to high net worth investors and tend to be looking for steady returns, downside protection and preservation of capital. Hedge funds have succeeded in delivering this, and the risk management functions at the top firms are market leading.

To invest directly or via fund of funds – that is the question

Finally, let's take a look at one of the largest trends within the industry; that of larger investors increasingly investing in hedge funds directly rather than through fund of funds.

Since 2006, of the allocations to hedge funds, those made to direct investments have jumped from 55% to 75%. By comparison, those made to fund of funds have shrunk from 45% to 25%.

Chart 4: Major trend – move from fund of hedge funds to direct



The primary reason for an investor to use a fund of hedge fund manager is to access instantly a diversified portfolio of fully vetted hedge funds. Fund of hedge funds are ideally suited for smaller investors who cannot meet the high minimum allocations associated with most hedge funds.

For many large institutions, investing in fund of funds was a first step that allowed them to become comfortable with investing in hedge funds. Many fund of funds hold well over 30 different hedge funds with some holding as many as 50. In some instances, this may lead to over-diversification and muted returns as good performance by some managers may be "zeroed out" by others. Going direct allows an investor to gain a more targeted, concentrated exposure to high conviction managers, with the goal of generating higher returns.

Fee savings are a primary driver for large investors considering a direct investment. We estimate a fee savings of around 75 basis points is achievable by from moving from fund of hedge funds to direct investments.

Other advantages of a direct investment:

- **Customization:** direct investors can drive the asset allocation and fund selection to suit their needs.
- **Control and liquidity:** by holding units of the individual hedge funds directly, the investor is not subject to fund of funds gating or side-pocketing investments.
- **Transparency:** by holding the hedge funds directly, investors can gain enhanced transparency.

Investing directly typically requires that the institutional investor have the internal resources to design, implement and manage a program. Investors without such capabilities will typically hire a consultant to help. (Note that it still may be worthwhile for smaller investors to hire a consultant to select high quality fund of funds.)

Of course, these are not the only options available. There are a number of different alternatives an investor can consider to access hedge fund strategies and new ones are continually being developed. 40 Act registered hedge funds are starting to gain some traction in the US and have some attractive features. UCITS in Europe and Closed Ended Investment Trusts in the UK have been around for some time but have had only mixed success. Specialised ETFs are also gaining traction and offer interesting alternatives. Investible Indices, hedge fund replication and alternative beta strategies will also be interesting for some and there are many products to choose from.

As a group, many of these alternatives to traditional hedge funds have attractive features, such as daily liquidity and lower fees. However the price of this is that many of them are more restricted in investment scope which can lead to potentially disappointing returns.

The next issue of *Insights* will feature an article on Operational Due Diligence, a critical element when choosing a hedge fund manager. Over 50% of history's hedge fund failures were facilitated by operational deficiencies.

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PAVILION WELCOMES...

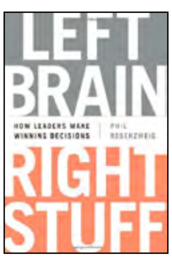
Stacy M. Walters, CFA
Research Analyst

Ms. Walters is a Research Analyst based in Chicago, IL. She serves on the research team for U.S. equity managers. Prior to joining Pavilion, Ms. Walters served as a Financial Analyst for The Newsweek Daily Beast Company where she led the close, budgeting, and strategic planning processes for the domestic publication. She also was an integral part of the sale process of Newsweek to InterActiveCorp, as well as the merger between Newsweek and The Daily Beast. Prior to Newsweek, Ms. Walters was an Investment Banking Analyst with RBC Capital Markets where she performed valuation analysis and was intimately involved in several transactions, including the closing of a $50 million convertible preferred stock. Ms. Walters graduated from The University of Michigan with a Bachelor of Business Administration degree from the Stephen M. Ross School of Business. She is a CFA charterholder and a member of the CFA Institute and CFA Society of Chicago.

Maggie Wang
Investment Analyst

Ms. Wang has joined Pavilion's Montreal office as an Investment Analyst, working with the broad consulting team, focusing primarily on the preparation of monthly and quarterly reports for our retainer clients, as well as on special projects to improve the quality and/or efficiency of our services. Ms. Wang earned a Bachelor of Mathematics (with Distinction) from the University of Waterloo and a Masters in Science (Financial Engineering) from HEC Montreal. She is also a candidate in the CFA Program (Level II). Her work experience includes two internships with CIBC, and one with the Caisse de Depot et Placement du Quebec.

BOOK REVIEW *By James McKeough, CMT, Global Macro Research Sales at Pavilion Global Markets*



Left Brain, Right Stuff: How Leaders Make Winning Decisions
by Phil Rosenzweig
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Most business strategy books are nearly useless when you try to apply their lessons to investing. They're overflowing with post-hoc sophistry, flow charts, org charts and pithy acronyms. They explain success by focusing almost exclusively on successful companies, despite the fact that failure, or at least muddle-through mediocrity, is the norm. Meanwhile, investors have learned the hard way that nothing recedes like success.

I've written that *The Halo Effect: Business Delusions That Deceive Managers by Phil Rosenzweig* is a notable exception. His latest book, Left Brain, Right Stuff: How Leaders Make Winning Decisions, is equally effective in tearing down more mythology in management theory.

I think this book is another must-read if you want to improve your analysis of strategic decision-making.

As it relates to investing, your own decision-making process should benefit as well. This book is more evidence that the best lessons from behavioral investing, ones that will change your own thinking and process, usually come from outside the echo chamber of financial markets.

Decisions Differ

Some business decisions are formulaic and data-driven, best analyzed by cold-blooded algorithms. But the decisions that get the most attention from consultants, pundits and investors are usually concentrated on strategy and vision. 'Bold and confident' are usually how successful CEO's are breathlessly described.

That is, until they fail, and then the verdict becomes one of arrogant overconfidence driving bad decisions. The flaws in this reasoning are obvious but rarely get scrutinized.

By analyzing how decisions are made in the real world, rather than in controlled experiments or hindsight storytelling, Rosenzweig once again challenges status-quo thinking. In The Halo Effect, the vulnerable targets were management gurus (Jim Collins, Tom Peters) but in this book, he's highly respectful of the pioneers in judgement and decision-making research, notably mentioning Daniel Kahneman, Amos Tversky and Richard Thaler.

Two Questions that Clarify

His central theme is that decisions need to be diagnosed before they're made. Diagnosed means understanding what kind of decision it is, a process that Rosenzweig crystallizes with two questions:

Can the outcome be influenced after the decision is made?

How will performance be measured, on an absolute or relative basis?

Put aside all of the modelling and theories and psychological profiling. These are the two questions that should frame your mindset- before the analysis begins.

In a recent Harvard Business Review article, Rosenzweig illustrated his model with this matrix:

As Rosenzweig acknowledges, research about how we make decisions in the lower left / first field is "thorough, met rigorous standards and rightfully changed the way we think about economic decisions". This is where our cognitive limitations can be most destructive. So in order to control for biases, a formal structure makes sense.

But what about decisions in the real world where finding a sample size of previous actions is simply unrealistic? Controlled experiments are acceptable in an academic setting, where ceteris paribus is a nebulous concept. But a major acquisition or roll-out of a radically new product is a different story.

The analytical, or deliberative, mind-set, as Rosenzweig refers to it, has been proven to work well when outcomes are random – or when performance is measured on an absolute basis. The 'getting things done', or implemental mindset, needs to be judged against standards that evolve with a changing marketplace. In other words, surprises can be opportunities or negative shocks but they can't be benchmarked against, or modelled for, if they really do come out of nowhere.

During a conversation that I had with him recently, Rosenzweig added more color to the book's key takeaways and added his perspective on applying them to investing. Rosenzweig leans towards recognizing a weak-form of efficient-market hypothesis. Fair enough, but another person pointing out that it's brutally difficult to get an edge isn't terribly helpful. However, he makes a careful distinction:

> *"There's always room at the margin for smart people who see things that others don't" and "a small intellectual edge in investing can make a huge difference in relative outperformance".*

This is the edge: while we can't control outcomes, we can control our processes, the people we work with and a client's expectations.

Rosenzweig stresses the difference between choosing and managing: *you choose an investment but you manage a portfolio.* The outcome of the former is largely beyond our control but the latter is always a work in progress.

Overconfidence is often singled-out by both cognitive psychologists and business strategists as the root cause of bad decisions: strong egos are a catalyst for weak choices.

Rosenzweig says this misses the point because what matters is distinguishing between different forms and levels of confidence. Yes, confidence about forces that are beyond our control (the economy, the competitive nature of the industry, publicly-traded financial markets) is misguided. But confidence about people and process is something different. Leaders need to exude this kind of certainty in order to inspire action. And portfolio managers need confidence in their process in order to weather those unavoidable periods where markets are punishing those on a different path.

As an investor, I've come across very few business books that can improve both our analytical skills and mental models for thinking. Phil Rosenzweig's books meet this very high standard.

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