Excess Returns

Monthly insights for investment marketing and sales professionals

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Behind every great investment company there lies a story. I'm not talking about the required philosophy-process-people-performance story. That story is important and it must be told well. I'm thinking of a different kind of story. I'm thinking of a story about strength through adversity or what the company learned the last time it really screwed up.

With best wishes,

Liz

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Alpha Partners is an investment marketing firm specializing in research and presentation strategy. Our goal is to create alpha (excess returns) by helping investment firms win, keep and diversify assets under management.

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Telling the Real Story

I am on the phone with the CIO of a long-standing client firm. We are doing an interview focused on his company's latest fund when I ask the question I always like to ask: "What mistakes have you made and what improvements in your firm's investment process and operations have you perhaps implemented as a result?" With that question, the interview gets significantly more interesting.

His response details missteps in assumptions about companies in different industries as well as situations that, due to elements of fraud, cannot be called "mistakes" exactly but can be processed as the need for greater portfolio diversification. He describes how his team conducts a regular portfolio review: what's working, what's not working and why. Based on this conversation, I not only understand in much greater depth what makes this firm tick but I also have greater confidence in the investment process and the people running it.

In life as in investing, if you want to test the mettle of teams, consider how they process mistakes. Do they learn from mistakes or seek to hide them? In a business such as investment management, where other people's money is at stake, the answer is critical. Unfortunately, though, investment companies don't always provide meaningful information about their mistakes — even in response to RFPs asking for information about mistakes and related lessons learned.

Capitalizing on Mistakes

I ask my friend, the Portfolio Manager C, about this. “Fallibility,” says C, “is not a trait that people look for in their money managers.” I know exactly what she means. Even I can recall a related new business presentation where I volunteered a mistake and described how our company had implemented processes to prevent such a mistake in future. Based on the subsequent win/loss interview (we lost), the person doing the hiring only remembered the mistake; she did not remember how we had become a better company as a result of it.

So are we all doomed to skating on the surface, presenting an official, sanitized, significantly less interesting version of ourselves for fear of being misinterpreted? Do we address our mistakes in public only when someone asks us a question about them? Or do we incorporate a description of our mistakes, along with our successes, into a story that is richer, deeper and more real?

The answer to these questions depends on the situation. There is an effective way to describe what your firm has learned through its mistakes — and an ineffective way. There is a right time to discuss mistakes — and a wrong time. The former enhances the likelihood of your being hired. The latter, while it may gain points for honesty, might well disqualify you.

In preparing to write this article, I’ve spent a lot of time thinking about mistakes: how to prevent them, how to learn from them and how to communicate about them effectively. In the process, I’ve developed a few related observations that I hope you find useful:

Mistakes are opportunities to learn. If you operate in a culture of blame and finger-pointing, then you may as well try to find another job as soon as possible. This kind of environment is lethal to investment performance and professional stability. Try instead to find or create a culture where mistakes are considered a foundation for improvement.

Process is everything. You have to be able to answer the question, “What are you going to do differently next time?” And you need to be able to answer that question from the perspective of your entire organization. In a recent issue of her company’s newsletter, Mariko Gordon, Founder, CEO and CIO of Daruma Asset Management, addresses the need for understanding how investment companies process investment and operational mistakes: “Investors performing due diligence may ask about mistakes, but they often do so in an anecdotal way. They’re more interested in specific examples of mistakes rather than assessing … what mechanisms firms have to systematically track and learn from mistakes … I would suggest that to ignore a firm’s culture around mistakes is … a mistake.”

Perfection is suspect. “People tend to come into a finals presentation,” a consultant once told me, “and say, ‘Every name we’ve had worked.’ We obviously know that this is not the case, so if someone comes in and is honest about their mistakes, actually it might be somewhat refreshing. It’s advice that I freely give to managers but they never seem to take me up on it.”

Timing is critical. The reason managers may not take him up on it has everything to do with timing and emphasis. If you are asked, during a due diligence meeting, for example, to address what your organization has learned from its mistakes, make sure your response is drawn from past history: long, long ago and far, far away. If the mistake is more recent, it is likely to ring alarm bells. Also, human beings these days have short attention spans. In the amount of time allocated for a finals, you may not want to risk any focus on a mistake, even a long-ago-far-away one. As our company learned the hard way, the audience may remember only the mistake, not the reasons why it will not recur.

Never avoid the obvious. If your firm’s mistakes are manifest in a significant period of recent underperformance or personnel turnover, then you risk more by not addressing them. Always feed your elephants.

For some reason I've been thinking about Bernie Madoff a lot recently, maybe because one of my neighbors had to sell everything, including his much beloved horses, due to Madoff-related losses. I watched with great sadness as all of his horses were loaded onto a big trailer, possibly to be taken for sale at auction. In his heyday, how did Madoff respond, I wonder, when asked about his investment mistakes? Or did anyone even ask him? Maybe not, because no one found out his real story until it was too late.

Sankofa Tales

In considering how investment companies learn from the past — their successes as well as their failures — I was delighted to come across a new book from Progress Investment Management Company: *Twenty: Then Now Next*, written by Thurman V. White, Jr., CEO of Progress, with Susan Orenstein to celebrate the firm's twentieth year. Consistent with the spirit of Sankofa (described at right), the book is an inspirational compendium of lessons learned by some of the 125 emerging managers that Progress has funded since its founding in 1990. *Twenty* includes interviews with many Progress managers and insights on surviving a tough market such as 2008, building successful teams and effective strategies for sharing equity. To obtain a copy, click here.

The mythic Sankofa bird flies forward while looking backward with an egg (symbolizing the future) in its mouth. To the Akan people of West Africa, writes Thurman White in Twenty, *Sankofa is "rooted in both humility and optimism ... it's about looking to the past to gain insights to live better in the future."*

The Blame Game

"Blame no one. Expect nothing. Do something."

— Motto of the NY Giants

In considering strategies for learning successfully from mistakes, I came across another great new book, *The Blame Game* by Ben Dattner with Darren Dahl. The central premise of the book is that blaming others doesn't work. For example, Mr. Dattner cites a study showing that organizations that blame themselves for their poor results achieve higher stock prices over the long term than those that blame external factors. Mr. Dattner concludes that "companies that tend to rationalize and blame their misfortunes on events they cannot control … cause investors to worry. While it might be tempting for executives to deny responsibility and blame factors out of their control for bad results, this strategy can backfire when investors wonder: 'If there are such important factors that are so far out of your control, why should we invest in your company?'"

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