Intro

Einstein story…

That's what I do for a living. I've been doing this now for virtually my entire career, which means I've made a lot of mistakes and learned a lot of lessons.   Over the next couple of hours, we'll discuss some of those mistakes and lessons.

- Not a lot of new lessons or insights, but just like with my 16-year-old it never hurts to be reminded of the lessons.

A preview, for those who can't last the next two hours, here are the six lessons:

- Link between dealing drugs and hedge fund management, implications
- Investing is like going on a cruise
- LIfecycle of alpha: Today's alpha is tomorrow's beta.
- Importance of culture
- So what are we doing here anyway? You'll know our two hours are almost over when I tell you a story about my dad.

Lesson 1: Alpha is a drug, everyone's hooked, we're pushers

Stated less cavalierly, it's all about alpha. That's what people want from us, and they can't get enough. It's an alpha business. If we deliver the alpha, then our clients are happy. Yes, there are a lot of other things we have to get right in our relationships with our clients, but it begins and ends with alpha. Sine qua non.

Norm: Client told me once, "I have bills to pay. Just make me money."

- implications? it tells us how to spend our time. How to prioritize our projects. How to recruit and retain talent. How to ....
- learned this lesson from my boss. He'd always ask why I was meeting with a prospect or client, and not focusing on alpha. "If you don't deliver the alpha, there'll be no clients to worry about," he'd say. Truth is, I did client meetings becaues they were easier than extracting alpha.

So why did I allow myself the distractions? Because there's nothing harder than alpha. The challenge is HUGE. It's one of the greatest intellectual challenges out there. We're competing against a bunch of highly motivated, very intelligent people in what's ultimately a negative-sum game.

- (Implication of negative-sum game is that if you lost alpha, someone in this room probably took it from you. You didn't lose it to the markets...you lost it to other market participants.)

Summarize: lesson is that alpha's a drug. Implication is that we must focus obsessively on that drug.

Exception: Recall a consultant who said, "My client doesn't want that source of alpha. He only wants alpha that comes from traditional stock picking sources."

- That's as irrational as saying, "My client will only accept money that's derived from businesses with tall CEOs." I'd have loved to have been able to talk to the client directly, but unfortunately in institutional space, the consultants are sometimes the gatekeepers.

Recall losing an argument with my boss over this once. He argued that the source or type of alpha mattered. Clients, when I asked them, were 99% on my side. The exception was a

But the difficulty of alpha is exactly the reason that we need to **focus** on it. Here are some of the things that I've allowed to get in the way of alpha:

- Business aspects of running a hedge fund. Performance reviews. Compensation season. Budgeting. People management. They're all easier than alpha.
- Asset gathering. Easier than alpha.
- Corporate distractions. Committees. Seminars. MD Offsite.
- Speaking at conferences. Still not sure what I'm doing here.

Let me give another version of a lack of focus. As investors/clients, this is one that I think you should be very concerned about, and it was perhaps the biggest business mistake I've ever made. Build 6 businesses at once…had a plan B and plan F. Also, intellectual servicing fallback, so plan G.

- We were failing on all six fronts. But felt that the business diversification was sensible. Who would put all their eggs into one basket? We even teach our clients about the benefits of diversification.
- Only succeeded when we turned everyone's attention to extracting alpha in the same single product. We no longer have a Plan B.
- not generally an issue for the "two guys and a dog in the back of a garage" hedge fund. But a potential problem with HF's buried in large organizations. Ask them, "What's your Plan B? How do you keep the team together if this fails?" If they have a Plan B, then don't invest.

Lesson 2: Investing is like going on a cruise. The journey is (almost) as important as the destination.

Family cruise to Mexico. Another cruise to Alaska. We're seasoned cruisers. Trust me... wonderful scenery in Alaska and great ports of call in Mexico. But that's not why we went on the cruises. We went for the journey, not the destination. The food. The service. The pandering to at every turn. The entertainment. THAT's what a cruise is about, not the destination.

Investing is the same. Yes, you all care about the destination (how much alpha you get). But you care almost as much about the journey (the path to get there).
- Evidence: Our FI hedge funds that had their worst years ever in 2008 also had their best years ever in 2009/2010. They've made back their losses, but the journey was just too painful for clients to stick around.
- Evidence: We could lose money in late 1990s by being overweight US equities, but not by being overweight Hong Kong equities

The key to a smooth journey is to avoid concentration. Fortunately, learned this -- the hard way, the very hard way -- before 2008.
- Give the 2002 story. 150% o/w equities in September. Five scandals: Adelphia. Martha Stewart. Tyco. Worldcomm. Enron. 11% stock/bond spread, down 16% that month.
- Response: Diversify at every stage of our portfolio construction process. Diversify across asset classes, investment horizons, insight families, market drivers and of course assets/ securities themselves.
- Result: Survived 2008, not because we got the bets right but because there was so much else going on in our portfolio (compared to competitors) that the crisis didn't do us in, like it did them in.
- Cost: lower capacity.

Lesson: journey as important as destination. Risk control is important. Learned through a serious mistake we made with our client's money.

Lesson 3: Lifecycle of alpha: Today's alpha is tomorrow's beta.

Alpha is any investment insight that hasn't yet been broadly exploited

Life cycle (3 phases)

- Initial insight works. It's alpha.
- Others adopt it so it works better. It's turbocharged alpha.
- Finally it's commoditized. Herding happens. We now have beta.

Example of SAE and history of quant investing…

- In 1980s, we and most of our quant competitors looked mostly at fundamental value and a few other simple (generic) drivers of stock returns. In 1990s, we all added measures of sentiment (eg, analyst revisions). So our models in the 1990s had two primary drivers of stock returns: Value & Sentiment.
- Then in early 2000s, we added earnings quality as a third driver of stock returns. We were the first to add this, and we did it before the Sep/2002 scandals rocked the global equity markets. Already talked about the scandals that month. Everyone woke up to the importance of earnings quality and started adding this to their models. We already had it, so they were all piling into our trades, giving us outsized returns.
- In 2007 we all discovered that our models were similar – we were all trading on the same three major alpha sources across a wide breadth of assets: value, sentiment and quality. Without realizing it, our competitive advantages were no longer advantages.
- Identify the lifecycle: Initially, it was an insight that hadn't yet been broadly exploited. It was alpha. Then others piled in and performance was great. Finally, so many had piled in they'd become commoditized. Herding happened. It was beta.

Many other examples:

- Carry (anyone trading currencies over last five years knows that the distribution of carry returns is different from five years ago,
- "Alternative beta"
- FX momentum in mid-2000s. Give story about Minder and the yen move due to momentum.

Corollary: Must never stop innovating.
Markets have changed over the 20 years I've been in them.

- Then, we could view Japanese auto manufacturers as Japanese stocks, pretty much ignoring developments in the US auto sector. Globalization has change that.
- Then, we could gather analyst data from third-party vendors as much as four weeks after the forecasts were made. The information revolution has changed that.

Result is that the speed at which our insights decay is faster. So we have to be faster, smarter, more nimble. (in 1997 analysts were still impacting returns three months after the forecast. Today, they have no impact even three days hence.)
Implication is that we can never stop innovating.

    - Our competitive advantage during these decades was breadth – the application of basic economic insights across thousands of assets. Perhaps you could say our advantage was *technology*, which allowed us to increase breadth.
    - Competitive advantage: Innovation … being first … having an insight before others had it … give us credit for this.
- Then, we could ignore the stability (or quality) of earnings and focus only on the size and growth rate of earnings. But today, the kinds of information being priced has changed.

Lesson 4: Importance of culture

At BLK, I've run many different investment businesses over the years. Some were more successful than others. The #1 business lesson I learned is the importance of a strong, healthy culture to long-run investment success.   Culture is the environment in which people identify insights (trades) that lead to alpha. Therefore, culture can be a competitive advantage, a source of alpha.   It can encourage, facilitate, generate alpha. But it can also be a disadvantage, a hindrance to alpha extraction. It can also impede, destroy or prevent alpha.

Furthermore, based on my experience, there are two very specific elements of culture that are directly linked to alpha extraction and risk control. These are necessary for long-run success of an alpha business.

- First, we have to be singularly focused on alpha extraction and nothing else. Our fiduciary responsibility is to our clients, not to our models or our processes or our trades or our business success. I call this an alpha culture. (Mentioned this back at lesson #1...shows how important it is.) I define an alpha culture... When everyone shares that definition of success, then look out...more innovation, faster innovation, more creative innovation, better exchange of ideas, ... which all lead to long-run alpha.
- Second, partnership. I define.... If we see that, then we get a greater leveraging of our talent, greater productivity, better communication, ..., all leading to more alpha.

Finally, remember that insights and trades can always be copied, but culture cannot. So if you agree with me that culture is the foundation from which we build our alpha extraction capabilities, then by building the right culture, we're building a long-run alpha stream that will allow us to continue to deliver investment performance at or above client expectations. And remember from the beginning of this talk that this is all that matters in the end.

But it's even more important than that.

- Culture is a recruiting tool
- Culture is a retention tool

Lesson 5: Why are we here? Who are our clients?

What are we doing here? We're creating a better financial future for our clients.
- Story about my dad.
- That's when it struck me...I'm still working for my dad!! I can't get away from him!

But what a powerful lesson. Why are we here? To help our clients. And our clients aren't ABC Corporation of XYZ Family Office or AGT (my dad's employer). Our clients are people like my parents and your parents, and millions of others like them. They want us to succeed; they need us to succeed.

I've been extremely fortunate to have been one of the successful ones over the years -- not because of anything I did or any investment decision I made, but because I'm surrounded by people who are way better at this than I could ever be.

I've made a lot of mistakes along the way, and learned a lot of lessons, some of which I've shared with you here.   My team has covered for me and made me look good. I hope you've got an equally strong team. If so, then you'll be able to get away with as many stupid mistakes as I have.

Just to summarize:
- Bottom line is that my dad will not have as comfortable a retirement if I don't focus on alpha. (Alpha is a drug...)
- He won't have as comfortable a retirement if I don't focus on risk. (Investing is like going on a cruise.)
- He won't have as comfortable a retirement if I'm not innovating incessantly. (Lifecycle of alpha...today's alpha is tomorrow's beta.)
- He won't have as comfortable a retirement if I don't build and preserve a strong investment culture on my team. (Importance of culture.)

1. **Importance of having and articulating a clear vision (Biggest management mistake):** LongHorizon example

Hang onto our losers too long: USTAA, Freddie Mac, Alpha Tilts, UK tilts

People buy products, not toolkits

Lesson 4: Beware of the hidden risks

Yeah, we all know about liquidity risk, counterparty risk, market risk, etc. These are the known risks. At least, they're known post-2008. But beware of the *hidden* risks.

Summer/2007 story about our response to the equity crisis. Identified five risks or dominos: Carry, Beta, FInancials, China and Flight to quality. Got out of the way of three of them. Traded over $30b in FX to do it. Two days later we get the massive carry unwind of Aug 16. And we had our worst day in years. But we got rid of carry, so what happened? Truth is it was perhaps the biggest investment mistake of my career. And that covers a LOT of mistakes.

- We had a hard time measuring our carry exposure. What we didn't realize was that we had a lot of carry exposure coming from the non-FX parts of our portfolio as well.
- And sometime prior to that, a client was concerned about our beta exposure. We had only a small equity overweight, so we weren't concerned. We didn't realize, but we were getting a lot of beta exposure through our FX portfolio.
- And during 2008, the correlation between the JPY and SP500 was about -80%, so we were getting beta from our short yen position. Etc., etc., etc.
    - To summarize, carry exposure can come from bonds. Equity beta exposure can come from currencies. Oil exposure can come from equities. Gold exposure can come from bonds. Every asset has a non-zero exposure to every conceivable source of risk.

Lesson: Have to measure it, monitor it, control it. We now measure the exposure of every security to every conceivable source of risk, so we always have a holistic view of the true risks our portfolio faces. So today, for example, we've got a beta of 26%, 9% of which comes from our currency portfolio and only 8% from FX.

If you ignore that, you'll end up surprised by a 65% correlation with the SP500, even though you're only trivially overweight equities. You'll be surprised that performance falls off a cliff during a carry unwind, even though you're long the yen.

There are two reasons this was an important lesson:

- We didn't have a good measure of what risks we were really exposed to.
- If you know your actual exposures, it's pretty trivial to adjust them. For example, we'd typically adjust risk exposures through only the most liquid assets (too much carry? just buy the yen, regardless of where the carry's coming from). Easier to manage risk. Made a huge difference during crisis.

Important Corollary: Beware of beta that comes disguised as alpha

- E.g., we drifted into a FI portfolio that was almost a replication of our carry portfolio. This was beta, not alpha.

Other random small lessons not included in the speech due to time constraints:

1. Don't practice on your best prospect
2. Don't fall in love with a trade/model. (Mistake I repeated the most often.)
3. Myth of orthogonality
4. Prepare for meetings (Hope Strout meeting on USTAA) (Biggest client mistake)
    a. Seminar participation and granting of tenure
    b. Last time I gave this same speech
    c. Unprepared for client meetings