Koedijk, Kees & Slager, Alfred. – Investment Beliefs

Palgrave Macmillan, 2011, [Finance] Grade ★★★

I'm of the firm opinion that all participants in the financial markets need a set of investment beliefs structured into an investment philosophy. That is, they need a view on how markets work and how money is to be made according to this. Why? Because to get an edge a firm must act coherently. Only when everybody in the organization walks in the same direction will it become strong enough to create exceptional results. The majority of pension funds and asset managers haven't specified what their edge is, and if they haven't figured that out then they most certainly haven't got one. Instead they mimic what other do, hire qualified personnel and give them good remuneration, close their eyes and hope for the best. The result is almost always that the firms at best perform in line with everybody else. At worst, they will switch methods that don't seem to be working anymore with the result that they will always be behind the curve, sinking deeper into mediocrity. The exceptional firms in our industry, whether it be Bridgewater, Vanguard, Baupost or someone else, all have clear investment beliefs, written or not.

However, an investment belief almost sounds religious. A tire maker, clothing retailer or a telecoms operator have strategies and processes but they haven't got individual beliefs on how markets fundamentally work. Why is the investment industry different? The investment industry is unique because human action creates a market in constant evolutionary change on a deeper level than most markets. In the tire industry the correctness of "if we make a better product at a lower price and sell it with superior after-market service through a world class sales force, then we will take market share" is not made invalid only because other try to do the same. If competitors in the investment industry all do the same, what they do tends to stop working. When too many engaged in portfolio insurance in the late 80's it increased the risks instead of decreasing them. Also, the sometimes ridiculously low signal to noise ratio in the industry allows participants to hold different but rational beliefs.

Kees Koedjik, Professor of Financial Management and Dean of the Tilburg School of Economics and Management and Alfred Slager, CIO at Stork Pension Fund have written the first book, to my knowledge, that explicitly discusses investment beliefs for pension funds. The text is divided into three parts where the initial one describes a framework where honestly assessed, well researched observations of the market and of academic research form the basis for investment beliefs. These are put into practice through actionable investment strategies and processes by an organization that should be formed in accordance to the beliefs and strategies. Over time the performance generated and new insights into how markets work feed through into new beliefs in a continuous feedback loop creating a balance between stability and adaptability. This framework is close to spot-on. Applauses are in place! My one quarrel is that I think the authors should have emphasized self-reflection more. Only through both self-understanding and market understanding will an investor be effective in developing an edge in the market. All investors differ both in institutional as well as organizational aspects in how they are able to compete.

The second and third parts of the book are more disappointing. The bulk of the text comments on a number of examples of investment beliefs and then in the end some advice is given on how to put it all into practise. The text is competent but also very conventional. There is nothing new for anyone who has given even a passing interest to the pension management industry the last ten years. This is the base set of knowledge for pension trustees globally (strategic asset allocation is priority number one, diversification is a free lunch, low costs counts, CSR is an opportunity, active management is a zero sum game etc.). The feel is institutional and academic rather than business like. It's a recipe for the ordinary, not the exceptional. I also have a few academic and intellectual objections to what is being said, but I guess we simply have different investment beliefs...

Ideally investment beliefs are set at an investment firm's formation but that shouldn't stop others from getting to work all the same. The first part of this book will be a very good start.

Mats Larsson, April 4, 2013