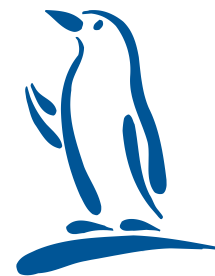


# Excess Returns

Monthly insights for investment marketing and sales professionals



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What's in your bug-out bag? As a denizen of the 21st century, you no doubt are aware that a well-stocked bug-out bag is key to any survival plan. But what about your investment bug-out bag? This issue of *Excess Returns* considers the implications of survivalist culture for investment management companies. Specifically, how can investment firms do a better job of communicating about risk?

With best wishes,

Liz Hecht

Founder, Principal and Director of Research

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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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## Doomsday Prepping for Investors

*“... the machines are going to fail, the political systems are going to fail, and a few men are going to take to the hills and start over.”*

— Lewis in [\*Deliverance\*](#), by James Dickey

The bad news is I've lost control of the clicker. The good news is, while being doomed (slight pun intended) to watching one of my husband's favorite and my least favorite television shows, I have an idea for this issue of *Excess Returns*. National Geographic's *Doomsday Preppers* profiles survivalist families getting ready for various forms of natural or man-made disasters ranging from global financial collapse to earthquakes to biological warfare (to name just a few).

Part of me gets this show. There is a certain appealing simplicity in the concept of survival: one is not overburdened with an abundance of choices; one's focus is clear. But I prefer not to envision a future without raw food restaurants, HBO and perfectly chilled Chardonnay. I do not want to take to the hills and start over.

As I watch this week's episode, however, it occurs to me that investment managers could learn from all these survivalist families stocking their bug-out bags and building their safe rooms. As evidenced by the number of wealthy investors with portfolios mainly in cash, bonds and gold, the investment industry can still do a much better job of communicating about the realities of risk.

## Best Practices for Communicating About Risk

After 2008 many investment firms improved the way they define, monitor and manage risk, and many more companies today now emphasize their risk management systems and strategies. Where I have not seen significant improvements, however, is in the way investment firms communicate about risk. The following best practices, when applied systematically, can turn communications about risk into a competitive advantage.

**Define terms first.** Your Great Aunt Tabitha and the CIO of a sovereign wealth fund are likely to view risk very differently. Investment company professionals therefore should communicate about risk in the context of what risk means to a prospective client. Is it something that can be described with a Monte Carlo simulation or something that inspires visceral dread? (Describing risk in the context of client goals seems obvious, but if it's so obvious why don't investment firms do this more often?)

**Demonstrate understanding of what could go wrong.** Communicating about risk has little to do with tracking error or standard deviations or correlation coefficients. The real risk that investors understandably fear is that their investment manager's worst-case scenario does not capture everything that might go wrong. "Understandably" because, as documented in *[Never Saw It Coming: Cultural Challenges to Envisioning the Worst](#)*, human beings do not excel at envisioning worst-case outcomes. Investors thus are likely to gravitate toward asset managers who acknowledge a complete spectrum of risk when describing individual investments and the portfolio as a whole.

**Communicate consideration of risk at every stage of the investment process.** The typical investment process map ends with the portfolio and then sometimes includes a separate page about risk management. The way one contains or capitalizes on risk should animate the entire process discussion — as opposed to being treated as an add-on or an afterthought.

**Give the sell discipline its due.** For many traditional investment strategies, a thoughtful sell discipline executed consistently is possibly the most important form of risk control. And yet one still finds detailed investment process descriptions — page after page of information on how the manager selects investments — without one drop of ink on when and why the manager sells. Similarly, a recent white paper on risk management by a large global financial services firm details 24 discrete forms of risk without any mention of faulty sell discipline implementation.

**Think big picture.** Portfolio managers routinely tell investors that they cannot predict the future. I always find these protestations to be somewhat wearisome, not the least because investment managers make them so often using exactly the same language (we don't have a crystal ball, blah blah). Of course these managers can't predict the future. But they can develop a well-informed global macroeconomic view, seeking to understand the full range of risks confronting their investors.

**Equate risk with returns.** Many investors still don't understand (or need to be reminded) that returns are derived from risk. Investment opportunities also arise based on ingenious humans finding new ways to prevent worst-case scenarios. An asteroid wiping out all or part of our planet strikes me as being the ultimate risk (sorry preppers, your gas mask or water purifier won't help you there). And yet a recent episode of *NOVA*, ["Asteroid: Doomsday or Payday?"](#) dramatizes how studying the risk of asteroids is already creating investment opportunities in space.

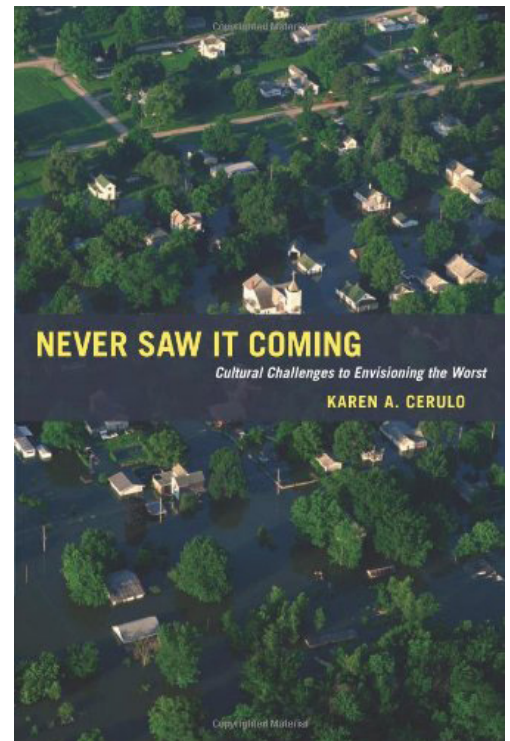
One of the main reasons I don't like *Doomsday Preppers* is that the preppers usually are blinkered in their focus on what could go wrong. Each prepper family, it seems, has zeroed in on just one disaster to prep for (this one over here is prepping for a cyber-attack while that one over there is wholly focused on the negative consequences of global warming). These preppers would have more credibility if they acknowledged the complete range of potential negative outcomes. That's what I want my investment manager to do.

## Envisioning the Worst

*Never Saw It Coming: Cultural Challenges to Envisioning the Worst* explores what author Karen A. Cerulo describes as “positive asymmetry” or the human tendency to imagine positive outcomes in greater detail than negative outcomes. Positive asymmetry, argues Cerulo, a professor of sociology at Rutgers University, can at least partly explain 9/11 and the 1986 Challenger disaster, while negative asymmetry helps to explain the avoidance of catastrophe in the case of the Y2K millennium bug and the SARS outbreak of 2003. For investment professionals who want to improve the way they think about and describe risk, this book is a must-read cover to cover.

## The Big Short Revisited

Speaking of negative asymmetry, I recently had the pleasure of rereading *The Big Short: Inside the Doomsday Machine*, by Michael Lewis. *The Big Short* tells the story of the people who understood the risks inherent in the subprime market long before those risks became front-page news. This is a classic well worth revisiting, and it may soon be a movie, too (Brad Pitt's production company, Plan B Entertainment, has optioned the film rights).



*In Never Saw It Coming, Karen A. Cerulo documents “positive asymmetry,” a phenomenon that may explain why so few investment firms communicate effectively about risk.*