Skill and Luck 1.

In the investment business, the need to distinguish between skill and luck is very important. But why?

I am in the investment business. My job is to find and invest with fund managers whom I consider to be good investors. But what makes a good investor? This is a length subject which has been dealt with by others. Matthew Ridley, who manages a fund of funds at Consulta has written an excellent book entitled How to Invest in Hedge Funds which goes into great depth what makes a good investor.

My interest is in separating skill from luck and even before that, asking if it is important at all to distinguish between the two.

In my search for investment managers I once visited a manager in New York who was reputed to be an excellent investor. As someone responsible for investing with managers it was my job to figure out if this guy was going to be able to make us money. Phil, let's call him Phil, was a distinguished guy in his late 40's or early 50's, it was difficult to look beyond his perma tan. We met at his office in Midtown Manhattan with a view over Central Park. Phil was clearly a successful manager. The fund he ran had over 1 billion USD in assets and he was generating good returns for the last three years.

Phil began by rattling off his CV. So many years at Drexel with Michael Milken and his group, that's how you really learn the business, so many years at Morgan Stanley, that's how you understand the institutional business, so many years at XXX Capital, one of the largest hedge and most respected hedge funds… It was very impressive.

Next, Phil launched into his investment strategy. He was always long volatility, he had a team of analysts who took a bottom up approach to investing and understood the portfolio companies as well as the CFO's of the companies did. He had a network of fellow investors whom he hob-nobbed with. Risk management? A Russian PhD in mathematics ran risk management.

Phil and his fund were very impressive but they would not discuss positions or the current or even a slightly outdated portfolio. He would not discuss example trades but spoke very generally of being long volatility, never taking tail risk, monitoring correlations, being long convexity, buying cheap optionality etc etc. Without going into some of the details of the portfolio, without access to his traders and without the opportunity to understand the motivation behind old successful or losing trades, all I had to go on was the track record of the fund. Phil was saying, trust me, look how much I have made for others before, I can do the same for you.

I was very impressed by the numbers, the CVs, the presentation, Phil's bespoke suit and expensive address. I told him I would take some time to think about it and that I would have follow up questions. Phil was all sweetness and light. In this crazy industry he was doing us a favour by taking our money. Call me any time, he said. Anything you need, just let me know. Yet all he would give me were sweeping generalities, not an insight into how he thought and how he invested. The number he was printing looked fantastic. 20+% returns every year in the last three years was good performance. I just couldn't tell if it was luck or skill.

Here's my problem with making money by accident. First of all, investing in hedge funds is expensive business. Fees are typically 2% of assets per annum plus a 20% share of profits. Find a skilful manager and that's cheap. Find a flukey one and 1% is expensive. When I invest with a manager who is skilled, they, and I, know why they made money at a given time. They also know why they lost money. That means that when things go wrong, they know how to react. Flukey Luke Capital who makes money by accident is risk because if they don't know how they make money, they certainly don't know why they lose it, and they don’t know what to do when they are in a losing streak. When in a winning streak, its easy. Stand on your position or increase it.

So how do you tell skill from luck? Well, I know when I have no chance of telling between them and that is when the manager is not willing to talk to me about their investment rationale in some detail. Transparency is a concept that has been discussed ad nauseum in our industry. Transparency has its uses. Understanding the strategy is one of them. It should be used wisely, however. Trying to make sense of a 15000 position portfolio list of ISINs is not helpful.

Also, it involves a lot of homework. I can usually conduct a coherent interview with an equity trader. Imagine if I was interviewing the manager of an Art Fund that invested in Asian Tribal Art. One has to know a bit about the particular industy in which the manager is involved in order to conduct a coherent discussion. If you don’t know, very soon the manager knows you don’t know and you are quickly at the mercy of their goodwill. Commonsense goes a long way. Whenever I can’t understand a particular strategy I go back to basics. There are limits, however, to the interviewee’s patience and good charity, and to one’s own professional reputation. Manager’s welcome intelligent questions. Don’t expect a tutorial on the dividend discount model or on discounted cash flow valuations.

Even after all this, its bloody difficult. Until today, the assessment of skill is more art than science. Very often it is a hunch that demands corroboration and evidence. Sorry I don’t have a recipe for distinguishing between skill and luck. Besides the obvious one: they did not know how they made or lost that money… It would make life so much easier if I had a checklist that I could fill that at the end said, this here manager has skill, or this here manager is just plain lucky, but alas, life is just not like that.

I would like to add one further thought: How do you tell poor skill from bad luck?