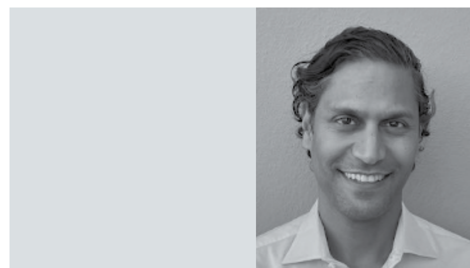
www.financialstandard.com.au
27 November 2023 | Volume 21 Number 23

SIXTH SENSE

Whether professional money managers admit it or not, there is a certain indefinable quality or *je ne sais quoi* that they rely on. In the investing world, Karren Vergara reports why there is as much value in rational analysis as there is in intuitive judgement.



01:
Ravee Mehta
founder, chief investment officer and managing partner
Nishkama Capital

02:
Paul X. McCarthy
adjunct professor
UNSW Sydney

03:
Angela Ashton
director and founder
Evergreen Consultants

Intuition. Gut feel. Hunch. Four words, that when mentioned around a wealth manager, are guaranteed to make them writhe with discomfort.

While most finance professionals know that investing is part art and part science, it is the former that they tend to gloss over, rattling on instead about the virtues of fundamentals or indisputable data and research.

Ravee Mehta[01], founder of funds management firm Nishkama Capital, which focuses on the technology, media, and telecom industries, hears hundreds of investment ideas pitched by analysts every year. Yet, only a select few strike a chord with him immediately.

Those select stocks, he knew, were already excellent trades before an analyst would finish speaking and well before he dissected the financials, specific company, and industry dynamics.

"Why did I gravitate towards certain investment ideas and not others?" he writes in his book The emotionally intelligent investor.

The best money managers, Mehta writes, recognise patterns developing ahead of most.

"Just like any other expert, professional investors have the capacity to build intuition through understanding patterns."

The longer-term investor builds such expertise in a way that draws on gut instincts – whether it be the business cycle, management's competency, a company's sustainable competitive advantages, regulatory and technology risks – and many other factors that can impact a company's earnings power, growth rate, and market valuation.

"The intuitive decision making that is involved with investing is much more complicated than other types of decision making. However, that does not mean that we should abandon trying to develop and use gut instincts when we invest," he says.

Even after reading the charts, flipping through pages of performances, and scrolling through research, the numerical fact-find can only get investors so far. Investors reach a point where after the methodological approach is exhausted, will draw on an inner knowing that an opportunity is indeed right for them or if a fund manager or financial adviser is someone they can trust their money with.

Personality, it seems, plays a major role in courting investors and one that is rarely talked about.

That is until a recent Australian study found that the success of a firm hinges on the leadership's personality.

Using artificial intelligence to analyse the Twitter profiles of 21,000 start-up entrepreneurs, the research led by UNSW Sydney and adjunct professor Paul X. McCarthy[02], correlated leaders' personality profiles with start-up database Crunchbase to determine if it influenced the firm's success, which could mean acquiring, merging or listing on the stock exchange.

Founders were then assessed on traits such as openness to experience, conscientiousness, extraversion, agreeableness, and neuroticism.

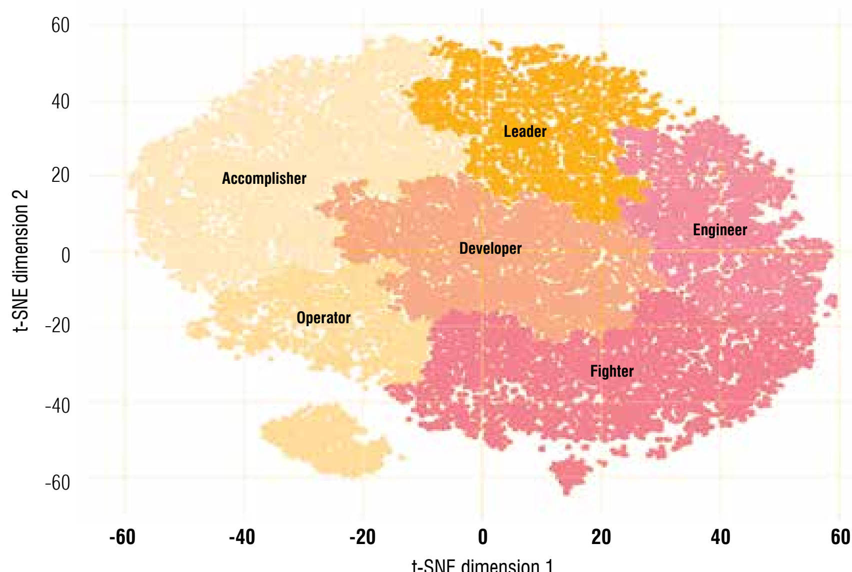
What distinguished the "successful entrepreneurs" included their preference for variety, novelty and starting new things; openness to adventure; being the centre of attention or lower levels of modesty; and being exuberant or having high activity levels.

What ultimately emerged were the six core personality types that successful entrepreneurs possessed (Figure 1). The more the founders exhibited these traits the higher chances of company success, the researchers found.

If the study was replicated for the wealth management industry, chances are, the findings would be similar.

"It is very easy to buy a manager who's very compelling. You often find managers that speak very well get lots of funds under management," Evergreen Consultants director and founder Angela Ashton[03] says.

Figure 1. Six types of founders



Source: Paul X. McCarthy, Xian Gong, Fabian Braesemann, Fabian Stephany, Marian-Andrei Rizoiu, and Margaret L. Kern.

Investment decisions should start with gut feelings but should always be guarded with logic.
Ravee Mehta

Not taking away from his abilities as a successful fund manager, Ashton points to Magellan co-founder Hamish Douglass, who she describes as an "extraordinary" and "one of the best" speakers that could engender confidence in people.

The managed funds industry oversees some $4.6 trillion in assets, according to the Australian Bureau of Statistics, and the competition for investor money has never been more fierce. The term *caveat emptor* has also never rung truer.

"It's easy to buy into the fund managers. People fall in love with them. You're buying charisma. It's the cult of charisma. You want to believe them and trust them," she told a recent *Financial Standard* Technical Services Forum.

"You want them to make your life easy. It's a very easy trap to fall into. Investors need to separate the quality of the presentation and the quality of the product, and that is sometimes very hard."

Skin deep

Scores of researchers find that good-looking people tend to experience preferential treatment and advantages – from the schoolyard to the workplace to legal proceedings. The funds management industry is no exception to the "beauty premium" or what is otherwise known as "lookism".

A study from the Shanghai Advanced Institute of Finance, which used an algorithm and volunteers to rate the attractiveness of fund managers, found that attractive ones scored more inflows, particularly if they performed well in the past. Male fund managers, meanwhile, draw in more inflows.

"We find that good-looking managers trade more excessively, prefer lottery-like assets and stocks with higher return volatility. They also exhibit more optimism when conducting market analysis in their periodic reports. These facts imply that good-looking managers could suffer overconfidence," the paper read.

However, the unattractive managers' portfolio tend to outperform those run by attractive managers by 0.17% per month.

Ashton urges investors to cut through the marketing and not be fooled by the superficial.

People unconsciously do buy good communication and the reputation of fund managers, she says.

The best place to start is to understand their philosophy, which too many investors overlook and dismiss as "not that important".

"Fund managers' philosophy is the central belief investors should come back to and assess to see if it aligns with how they invest. Take the philosophy and objectives of a value manager, for example. What is the value manager's process that leads them to value stocks?" Ashton says.

Whatever the philosophy may be, it needs to

04:
Thomas Tam
head of global equities
UniSuper

05:
Tricia Nguyen
head of Mercer Sentinel
Mercer Australia

06:
Greg Davies
head of behavioural science
Oxford Risk

have a consistency and truism and logical approach to it.

Another red flag is if managers do not co-invest in their own fund.

"Ideally, the fund manager should not invest in funds other than their own, particularly if it's an equity fund. You want them to have skin in the game as much as you," she says.

Another pitfall is buying into short-termism.

"Fund managers need to be able to prove that they are long-term thinkers because the reality is alpha is a long-term idea. Independent thinking is also important. They need to have that mentality, particularly for equity managers. It is not about next quarter's results."

The stakes are high when it comes to the $3.5 trillion superannuation sector selecting which fund managers will best oversee and grow members' money.

Institutional investors typically undertake quantitative and qualitative approaches in determining who they award mandates to.

But the ratio between crunching the numbers and spending time on what's not easily quantifiable can't truly be apportioned.

It does not come down to a 50-50 split, according to UniSuper head of global equities Thomas Tam[04], nor is it 70-30.

In assessing which fund managers will join its stable, UniSuper's first step is a quantitative exercise that uses Evestment to analyse external managers.

"Once we identify managers that we like, we ask them to send their performance data and holdings since inception. We run the data through our risk model to work out their particular styles, biases, and if they can consistently outperform the market to generate alpha over the long term," he says.

"If we added a manager, does it help improve risk-adjusted returns? Does it help reduce risk? What's the contribution to the overall tracking error for our equities book? For us to add them, it must contribute in either improving returns or reducing risk."

This could take between two weeks to a month. Once that lines up, the qualitative component involves a series of meetings with the lead portfolio manager and a team of analysts ideally face to face.

At the time of the interview, Tam and his team were on their sixth call with a potential manager.

"First and foremost, we want to understand the philosophy. How does the manager determine mispricing in the markets, stocks, countries, and different sectors? Overall, we're trying to gauge the temperament. Can this portfolio manager consistently make money for our members and generate returns above the market on a long-term basis? This is where internal teams help," he says.

"I can't emphasise enough the importance of having internal teams work with external managers. We can ask the external managers the tough questions, because we know what's happening with the stocks and done a lot of the work ourselves."

For institutional investors, the stakes are high when it comes to partnering with a third-party provider – whether it be a fund manager or custodian.

Choosing the right managers, says the head of Mercer Sentinel Tricia Nguyen[05], involves a deep dive into their processes and controls to ensure that the mandate that they've been given or the investment strategy that they expected to implement reflects the end-to-end operating environment and is fit for purpose.

"It's not quantitative in the sense that we give them a numeric score that is derived from, a formulaic approach," she says.

"It is based on our qualitative assessment of their operating environment seeing how that potentially could stack up in a possible worst-case scenario."

It is incumbent upon Nguyen and her team to spot all the risk considerations that clients need to be aware of.

"How could that potentially be mitigated, in terms of comparing this manager to their peer group of a similar size, complexity, the types of strategies that the manager is implementing?" she asks.

Their task at hand isn't so much about challenging managers' investment philosophy, rather to determine what rigours are in place to enable them to bring that philosophy to life so as to protect the interests of clients or investors.

"Operational due diligence has been increasingly important component of the selecting fund managers and outsource provides such as a custodian. There is much greater awareness and appreciation that this component cannot be underestimated," Nguyen says.

"If you don't duly consider the operational due diligence aspect when making these selections of the managers or the outsource custodian, then it could potentially lead to significant operational leakages. Ultimately, that means that it's going to detract from the performance of the investment manager and cause losses or errors, and not to mention reputational damage that cannot be rectified."

Clients first

A certain power dynamic takes place the moment prospective clients and financial advisers shake hands for the first time – the latter assumes the role of expert – and in an instant, the transferral of good faith and trust takes place.

But to this day, policymakers and regulators grapple with how the financial services industry can truly uphold their fiduciary duty, which mandates professionals to put above all else, a client's best interest first.

The investing world, says Oxford Risk head of behavioural finance Greg Davies[06], is riddled with dozens of "experts" who often contradict each other – and do so with sophisticated reasoning and great confidence.

There are outdated advice practices that don't adequately differentiate between an individual's psychological risk tolerance, and the financial capability to take on risk.
Campbell Heggen

Information asymmetry leaves clients, particularly those with low levels of financial literacy, in a vulnerable position, and ill-equipped to discern who to believe and ultimately who they can entrust their money to.

Davies suggests several ways clients can cut through the smoke and mirrors.

"Avoid investment forecasts and 'experts' who are highly specific, certain and confident, exhibit hubris and do not explore contrary probabilities, betray a misplaced confidence that the future is knowable in advance," he says.

Then there are financial experts who are provocative or biased and show no evidence of testing his or her own position or argument.

"Seek those who forecast in line with sensible long-term principles of investing," Davies says. "[Financial experts should] acknowledge the inherent uncertainty in investing, is humble and sceptical of both expert opinion and received wisdom and that the future is fundamentally uncertain."

Bravado or overconfidence in what they "know" is another warning sign clients should look for and the information should be taken with a grain of salt.

Davies adds that the financial professional should "acknowledge the full complexity of a situation and shows evidence of using multiple mental models in thinking about the world".

Before being sentenced to 10 years in jail, former financial adviser Terence Rio Nugara[07] stole more than $10 million from unwitting clients to fund his lavish lifestyle.

At his October sentencing, the Victoria County Court heard that Nugara would go the extra mile to woo his clients, many of whom he had a pre-existing relationship with, promising "high returns" on property investment after two to three years.

The victims described how he would "lull them into a false sense of security". For some, he would visit their home or retirement facility, bringing flowers, and buying them lunch.

Davies says that a financial adviser must be interested in the underlying truth rather than creating a sales narrative and "clearly played devil's advocate to their own thesis and looking for possible alternatives".

"Do they explore your whole financial situation? Advice can only be suitable if it takes into account all aspects of your circumstances," he points out.

"Do they show evidence of really strong repeatable process in arriving at their advice, using tools and technology to eliminate bias and subjectivity? Or does their advice seem to rest on subjective expertise and opinion – in which case – avoid."

Given that people "deviate from traditional standard norms of rationality, and are susceptible to making decisions based on emotions, existing beliefs, and things that make us feel good while avoiding what make us feel bad," Deakin University senior lecturer in financial planning

07:
Campbell Heggen
senior lecturer in financial planning
Deakin University

08:
Manisha Bhudia
senior financial adviser
Wealthwise

Campbell Heggen[07], who teaches financial behaviour and decision making, says that advice strategies and process can accommodate these phenomena.

"Rather than try to cure behavioural biases, which I believe is a misinformed approach, how can we leverage these natural tendencies and use them to our advantage when developing strategies?" he asks.

"How can we redesign our financial planning processes to remove frictions and barriers that might impede people from taking action when they really want to make it as easy as possible to implement our advice?"

Many experienced advisers Heggen works with know that the templates and tools at their disposal are not necessarily fit for purpose and too many pro-forma documents aren't based on contemporary approaches and could benefit from an update. Many are simply constrained with what they have.

"There are outdated advice practices that don't adequately differentiate between an individual's psychological risk tolerance, and the financial capability to take on risk," he says.

"We can't take a template approach to financial advice. We need to be working with the individual. The reason that's powerful is it helps us provide customised advice. The more customised advice is the more it meets regulatory requirements; the more likely someone is going to follow it."

For Manisha Bhudia[08], a senior financial planner at Wealthwise, intertwining behavioural finance throughout her advice process makes method stand out from others.

"Every decision that we make moment to moment is driven by an underlying emotion. For example, when we feel like eating a certain type of food, it comes from a feeling because you are seeking a certain experience," she says.

In financial advice, a client would say, 'I want to save up for a dream home, this is what I've always wanted.' Achieving that goal subsequently fulfills a certain experience the client is seeking.

"In all these outcomes we strive for, there's an underlying emotional current that is in motion, and it's this very current that drives and motivates us and ultimately makes us swing into action," she says.

"In my advice process, to unpack and then integrate emotions and finances is my key to delivering long-term sustainable financial outcomes. I help clients dig deep down into the core of what is their 'why'."

For Bhudia, unlocking the 'why' has proven time and again to bolster client-adviser connections.

"You can have all the technical skills in the world; it can be learned but the innate ability to establish a connection is something you cannot fake; emotions cannot be taught, only experienced. For me, drilling down to the crux of that 'why' is what has led to a consistent and engaged adviser-client relationship," Bhudia says.

Empathy then becomes a crucial component of this process. Being empathetic typically involves walking in someone else's shoes on the surface.

But it requires more than that. Empathy requires undivided listening skills, being cognisant of body language and other non-verbal cues, identifying one's own biases, and championing commonalties instead of differences.

"I look at it from their perspective and ask myself, 'What experience are they seeking out of this?' Once I'm able to nail what feeling it gives them, then I'm able to come up with a solution, which I know aligns to that experience," she explains.

One important theme Bhudia observes among clients is the "fear of the future" – which can mean different things to different people at varying degrees.

Advisers, she says, play an integral role in helping unpack this fear and get them on the other side of this fear.

"Vulnerability is one of the key aspects of behavioural finance because for clients to show vulnerability, it takes courage for them to share their journeys and their 'why'," Bhudia says.

For Bhudia, it's important that she creates a space for them to be vulnerable and not feel judged. It is also equally important for her to be aware of her own state of mind, body language and tone because they all come together to build trusted connections with clients.

"People want to deal with people who exuberate vibrancy, energy, and purpose, and it's convergence of these traits and your demeanour that helps build long lasting trust," she notes.

"Now, imagine walking into the meeting with low energy, and your body language is not very receptive. People pick that up straightaway and you can easily disengage a client without speaking a word."

Many of the non-technical skills, such as emotional intelligence and people skills, can only be learned and developed in practice. And many experienced advisers would acknowledge this.

However, it is fair to point out, Heggen says, that not all clients need behavioural coaching and counselling.

Even on this point, he says it comes down to "having the emotional intelligence to be mindful of what the client is going through, because often we work with individuals who are going through periods of change".

"Those periods of change are not always positive life events, often they are but often they are not. Having the interpersonal skills and maturity and awareness to be able to deal with that is something that comes with experience.

"Exposing young, new entrants and helping them be aware that it is part of the job is an eye opener for a lot of students who have not actually considered that aspect," he says.

You often find managers that speak very well get lots of funds under management.
Angela Ashton

Grandmasters

Talk of intuition and the anomalous continue to be taboo among wealth managers who prefer to expound the merits of conscious deliberation and reasoning over the instinctive.

Nishkama's Mehta says that, contrary to what many people believe, intuition is not some sort of "magical sixth sense" but an emotion that arises from pattern recognition.

"The best traders and investors seem to use something more than rational analysis. Even those who have highly analytical process for evaluation investments often rely on their intuition to decide on which potential investment to analyse," he says.

"They also rely on their intuition to make subjective opinions regarding management competency, a new product's potential, regulatory risks, competitive dynamics and many other factors that can impact a potential investment."

Like chess champions, Mehta believes that investors who have built adequate expertise should employ gut instincts. Not doing so would ignore years of experience and training.

"Investment decisions should start with gut feelings but should always be guarded with logic," he says.

"The best investment managers are constantly evolving and developing new gut instincts. This is mainly accomplished through introspection. Therefore, clients should look for investment funds that have a good process for examining prior decisions. Finally, clients should rely on their own gut instincts regarding the trustworthiness, self-awareness and competency of the fund managers investing their money."

In 2016, a study published in *Scientific Reports* found that in the pressure-cooker world of trading, UK traders who were more self-aware and in tune with their bodies were more profitable.

The researchers examined 18 male traders buying and selling futures contracts. They grasped the ability to assimilate large amounts of information flowing through news feeds, rapidly recognise price patterns, and make large and risky decisions with split-second timing.

The researchers monitored their heartbeat detection skills and found that the traders were more aware of their own heartbeats compared to a control group.

This "interoceptive ability" enabled their relative profitability and longevity in the financial markets.

"Traders in the financial world often speak of the importance of gut feelings for choosing profitable trades. By this they mean that subtle physiological changes in their bodies provide cues helping them rapidly select from a range of possible trades the one that just 'feels right'," the research found.

"Our findings suggest that the gut feelings informing this decision are more than the mythical entities of financial lore – they are real physiological signals, valuable ones at that." **FS**