Minority Rapport: In Praise of Being Different

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To be extraordinary, you must first be different.

"Think different."
— Steve Jobs, 1997

"Easier said than done."
— Anon, 2018

In 1850, Danish writer, existentialist philosopher, and thinker Søren Kierkegaard wrote in poetic terms about the eternal struggle between the minority and the majority:

"Truth always rests with the minority, and the minority is always stronger than the majority, because the minority is generally formed by those who really have an opinion."
— Søren Kierkegaard, 1850

Over a century later, Thomas Kuhn published *The Structure of Scientific Revolutions*, asserting that scientific truth was nothing more than a consensus view that could be upended at any moment in a paradigm shift in which "normal science" gives way to "revolutionary science" in an abrupt and unconventional shift, and a new consensus and "truth" subsequently formed.

Kuhn's ideas were powerful enough to be applied across disciplines, including economics, with the post-Great Depression Keynesian Revolution supplanting orthodox classical economics, itself ultimately challenged by Friedman's Monetarist Revolution in the 1970's.

The ethos of "truth defined by the minority" has important implications for investing as well, not just in diversity of gender, orientation, race, or religion, but even more fundamentally — in diversity of thought.

Why Think Different?

To be extraordinary, you must first be different

"Two roads diverged in a wood, and I — I took the one less traveled by, And that has made all the difference."
— Robert Frost, 1920

Another word for different is "unpopular." A team of researchers at Morningstar/Ibbotson Associates has just written a monograph entitled *Popularity: A Bridge between Classical and Behavioral Finance* which explicitly links differential returns to popularity: "Assets are priced not only by their expected cash flows, but also by the popularity of the other characteristics associated with the company or security. Less popular stocks have lower prices, thus higher expected returns. More popular stocks have higher prices and thus lower expected returns."

The authors tested their hypothesis by comparing equity returns for companies based on certain "popularity characteristics:" brand, strategic power, reputation, and prior performance. Not entirely surprisingly, returns were worse for the more popular companies, and better for the less popular ones. But — very surprisingly — the authors found that in many cases the better performing companies did so with lower risk! "Either risk is popular under some circumstances, or other non-risk characteristics dominate returns." In this new framework, unpopular assets produce better absolute returns and better risk-adjusted returns.

The authors also note that the only way to access these excess returns is to be different: "Going against the collective wisdom that drives popularity is inherently contrarian." In other words, being different creates alpha.

Edge depends on difference

"The reasonable man adapts himself to the world. The unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man."
– George Bernard Shaw, 1903

Edge is an important concept in both manager and security selection. Also known as competitive advantage, strategic advantage, or power, edge necessarily entails being different. In *7 Powers: Foundations of Business Strategy*, author, strategist, and investor Hamilton Helmer introduced the concept of counterpositioning. Counterpositioning occurs when a new entrant to an industry adopts a strategy that is so different from the prior norm, incumbents are unable to respond without destroying their own business model. Disruption (a paradigm shift) subsequently ensues, and value is created by the innovator and destroyed by the incumbents. Netflix checkmated Blockbuster using counterpositioning.

Difference is fleeting

"Our competitive myopia has created a dynamic in which our tendency to mirror the movements of our competitors has started to become reflexive."
– Youngme Moon, 2010

In sociology, the principle of reflexivity refers to the capacity of an individual to recognize forces of socialization and alter their place in the social structure. George Soros referred to reflexivity in his book *The Alchemy of Finance*, noting that the actions of investors can change based on the actions of other agents, actors, and counterparties, resulting in a highly uncertain and dynamic environment. An initially unpopular investment offering a higher return may over time become more popular, shifting potential future returns lower. This dynamic means the consensus is continuously migrating towards the truths revealed by the most successful investors (already among the minority) who must again depart from the mainstream in a continuous fight to maintain their edge. *[Continued on Page 11]*

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While the benefits of diversity in thought and action are clear, the pursuit of independence is not easy, costless, or riskless.

What Pushes Us Toward Conformity?

Human instinct and ambiguity aversion

> **"The yardstick for a human being is: how long and to what degree he can bear to be alone, devoid of understanding with others."**
> — Søren Kierkegaard, 1850

In his book *Influence: The Psychology of Persuasion* Robert Cialdini identified six biological instincts that drive our behavior. Among them is our natural tendency to conform, the so-called "bandwagon effect," and our natural tendency to defer to authority. Perniciously, when these two instincts converge in a highly uncertain, unknown or risky situation, they amplify each other — when faced with ambiguity, individuals are more likely to accept the actions of "experts" as correct, and to follow the crowd.

Comparative performance measurement

> **"Nothing generates conformity quite so organically as a comparative metric. When someone shows us the areas in which we are lagging our rivals, it is almost impossible for us to resist the urge to play catch-up. The result is a degree of competitive herding that can border on the nonsensical."**
> — Youngme Moon, 2010

Performance matters in investment, and we have a myriad of ways of measuring it. Unfortunately, the very act of measuring performance in a comparative way (e.g., versus competitors or peers) can result in increased conformity. It is human nature to focus on fixing flaws rather than extending advantages. Unsurprisingly, when weaknesses are identified in comparative performance measurement, eradicating them typically becomes a focus, resulting in atrophying advantages and decreased diversity. The maxim "compare and despair" truly applies in investing!

Governance

> **"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."**
> — John Maynard Keynes, 1936

There may be principal-agent style incentive misalignment between an institution's board (the principals, who may prefer to minimize the risk taken in the portfolio) and the investment team (the agents, who are likely motivated to seek higher return, but potentially riskier investments). Unless there is strong alignment of beliefs and significant trust between the board and the investment team, when a unconventional approach results in relative underperformance, there is often pressure to shift towards a more conventional approach.

A multitude of forces is pushing us to conform. How can we fight our natural instincts, develop more comfort with ambiguity, improve our governance processes, and better align incentives to give us a greater chance of meeting our long-term objectives?

Strategies for Effective Independence: Resisting the "Urge to Herd"

Think

> **"The Thinker... will never be popular, not because he is difficult, but because it demands quiet and prolonged working with oneself and intimate knowledge of oneself as well as a certain isolation."**
> — Søren Kierkegaard, 1850

First and foremost: "Think." I have been given this simple, direct, and unsolicited advice independently from two of the smartest, wealthiest, and most successful investors I know. Kierkegaard, the aforementioned protagonist of the minority, believed that our inability to pause and think deeply — "to go alone into that secret closet to commune quietly" — is what causes us to relinquish our independence and instead adopt a view based on the "very loud talk" of the crowd.

Nobel prize winner and behavioral psychologist Daniel Kahneman identifies two types of thought processes in his book *Thinking Fast and Slow:* System 1 ("intuition" or your "gut") and System 2 ("analytics" or your "brain"). While System 1 helps us to quickly, confidently, and effortlessly synthesize the world, it often suffers from irrationality and overly creative pattern recognition, sometimes confusing signal with noise. System 2, more time-consuming, inefficient, deliberate and rational than System 1, works to avoid those mistakes, reduce overconfidence, and to flesh out the necessarily limited and illusory world created by System 1. However, System 2 is not perfect either — it can fail if it bases its analysis on information that is not representative.

Both systems have advantages and disadvantages. Both should be used when making decisions. Listen to your gut *and* use your brain. Make time to develop your own views, whether they end up aligned with consensus or not. Think.

Emphasize the long-term

> **"If we want to build innovative organizations, we need to create environments in which we are comfortable suspending our disbelief enough to let it happen ... to give our most unconventional ideas a chance to breathe a little bit, before subjecting them to the scrutiny of the naysaying sides of our brain."**
> — Youngme Moon, 2010

Benjamin Graham wrote about the risks of contrarianism in his book *The Intelligent Investor:* "Buying a neglected and therefore undervalued *[Continued on Page 12]*

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issue for profit generally proves to be a protracted and patience-trying experience. And selling short a too popular and therefore overvalued issue is apt to be a test not only of one's courage and stamina, but also of the depth of one's pocketbook."

The risks of being different have recently been further quantified by Fama and French, whose paper Volatility Lessons (2018) confirms the strong long-term value creation potential from investing in traditionally less popular small/value stocks, but highlights the not-inconsequential possibility of the factors substantially underperforming the overall market at times. Alas, even three- or five-year periods may not be long enough to validate the effectiveness of an unconventional strategy.

As investors, we are all beset with feelings of uncertainty, skepticism, and doubt when outcomes are not as expected. Remembering that unpopularity is one path to higher returns can be a touchstone for keeping the faith. Investing in the unpopular is ultimately a "long-term right" strategy that can often be "short-term wrong."

Be humble: focus on process, not outcome

> **"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."**
> — Mark Twain, 1874

Many investors are familiar with the quote above, which was featured in the opening of the movie *The Big Short.* In a wonderful ironic twist, it turns out that the quote is actually misattributed! Josh Billings, an American humorist, should be credited with originating the sentiment in 1874. As an investor, I have trained myself to welcome that feeling of surprise when a strong belief I've held is overturned. It reminds me to stay humble.

When we bask in the confirmatory glow of a good result, it is easy to believe we "knew for sure" that it would occur, and when we experience the sting of a poor result, it is instinctual to want to abandon the process that generated the pain. Neither posture is optimal — overconfidence causes us to bear unnecessary risks, and underconfidence causes us to forego potential returns.

In her book *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts,* professional poker player and cognitive psychologist Annie Duke writes about the dangers of "resulting" — the tendency to judge decisions based on outcomes. Resulting is inefficient at best, conflating skill and luck, and destructive at worst, reinforcing poor decision-making and impairing future outcomes.

No matter what has happened, good or bad, the best path forward is to ensure that subsequent decisions are sound. Focus on process, not outcome.

Conclusion: Celebrate the Different

> **"It is not the critic who counts; the credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat."**
> — Teddy Roosevelt, 1910

To those in the extraordinary minority of outperformers, I congratulate you and urge you to stay humble. To all those in the besieged minority of underperformers, I thank you for your contributions to dispersion and wish you well in your continued fight against conformity.

And to all who are truly different, striving to be extraordinary, I offer words of solidarity and support: Think. Cherish the unpopular. Challenge consensus. Balance humility and hubris. Look forward, not backward. And focus on the long-term. Paradigms eventually shift…

Related Readings

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Duke, Annie (2018) *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts.*

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