

## Thinking About Risk

Address by David A. Salem  
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My friends at NACUBO were nice enough to let me choose what to talk about here today, and I've decided to give you an updated and expanded version of a talk that I gave to a Common Fund gathering last winter about two of my favorite subjects: risk and baseball. Some of you may think this is an odd combination of topics to discuss, but those of you who've spent any amount of time interviewing money managers know that in the history of recorded time there has never been a single instance of a money manager giving a presentation without using at least one baseball metaphor.

The simple fact is, baseball and investing have an awful lot in common. The most obvious thing they have in common is that many of the people who make their living either managing money or playing baseball are grossly overpaid, which is probably a fairly reliable indicator that both of these industries may be headed for a shakeout in coming years. A second thing that baseball and investing have in common is that to do really well in either field, you need to take calculated risks. Taking calculated risks is, of course, a prerequisite for success in many fields of endeavor, from mountain climbing ... to cardiac surgery ... to driving on a freeway overpass in Los Angeles, but what sets baseball and investing apart from these other activities is that, as will undoubtedly be emphasized repeatedly at this seminar, they are both essentially zero-sum games: the only way you can win at either baseball or investing is to inflict losses on someone else.

Baseball and investing have other things in common too: as someone once said about war, they both involve long periods of waiting punctuated by fleeting moments of frenzied activity, and no doubt partly because both baseball players and investors typically have lots of time on their hands, both fields have produced a rich tradition of anecdotal humor. In fact, as you'll discover, I'm going to use baseball anecdotes to illustrate several of the points I want to make today about risk, starting with perhaps my favorite baseball anecdote, which involved the great pitcher for the St. Louis Cardinals, Bob Gibson. When asked one day why Gibson won so many games, one of his teammates was heard to mutter, "Gibson is the luckiest pitcher I've ever seen. He always pitches on days when the other team gets no hits."

My chief aim here today is to outline some steps that you yourselves can take to ensure that your own endowments are lucky in the same sense that Bob Gibson was lucky. As we all know, there are many Bob Gibsons in the field of investing — people who appear to be lucky but who have in fact succeeded by being either more disciplined, or bolder, or both, than the people they're competing against, thus enabling them to inflict losses on the other guy. Those of you who watched Gibson pitch know that he was both very disciplined and unusually bold, not in a foolhardy sense but rather in a very calculated sense. Gibson's game plan was very simple: most of his pitches were what one might call calculated risks — thrown to places that batters would find tempting but nonetheless

difficult to hit — while the remainder of his pitches were thrown as close as possible to a batter's head without actually hitting him.

Gibson didn't intend to hurt anyone, of course, he was simply trying to shift the odds of success in his favor by getting batters to think more about avoiding getting hit by the ball than about hitting it. Judging from how far back behind the Cardinal's catcher they stood when Gibson was pitching, it appears that Gibson also succeeded in striking terror in the hearts of certain umpires. This was probably a good thing, because as is still the case some umpires had a hard time following the flight path of a ball hurtling at them at a hundred miles an hour. In fact, one umpire got so upset by some fans who were loudly and rather rudely questioning his eyesight that he walked over to them and said, "There's nothing wrong with my eyesight — I can see the sun, and it's 93 million miles away."

Turning back to investing, I'd like to tackle head-on the question of how you as an investor can shift the odds of success in your own favor, just as Bob Gibson did whenever he took the mound. Obviously, you can't mimic precisely what Gibson did, because as investors you typically do not know and cannot know the identities of the other players whom you're attempting to inflict losses on, so you can't rely as Gibson did on a strategy of manipulating these other players' hearts and minds, or at least you can't do so legally. What you can do, however, is to shift the probabilities of success in your favor by exploiting in a disciplined manner some of the natural human tendencies that dominate investors' behavior, including the most dominant tendency of all, the natural human instinct to focus on what could go wrong with an investment, as opposed to what could go right. It was precisely this human tendency to focus on what could go wrong that Bob Gibson sought to exploit — indeed to amplify — by dialing an occasional knockdown pitch into his repertoire of hittable strikes. And it is precisely this natural human tendency to view risk in negative rather than positive terms that prevents many investors from achieving more favorable results. Many investors have been so conditioned to examine carefully the risks inherent in each investment that they make — to make sure that their downside is tolerable — that they ignore entirely or give short shrift to the important question of whether their upside is adequate.

So that's my thesis for today: as you go about your work as endowment officers or trustees, and especially as you consider broadening your endowment's reach beyond domestic stocks and bonds, I would encourage you to consider very carefully the risks inherent in every opportunity that comes your way, not to make sure that these risks are sufficiently low but rather to make sure that they're sufficiently high.

I promised the folks at NACUBO that I would illustrate this thesis with some concrete examples, both good and bad, of the type of behavior I have in mind, and I will of course do so, starting with some examples that many of you are probably familiar with. The most obvious example is, of course, the sorry saga of institutions that piled into small cap stocks in 1983, largely as a result of the so-called long-term studies of their risks and rewards that appeared at about that time. In hindsight, we can now see that the institutions that loaded up on small stocks at what proved to be a secular peak in their relative returns did so using a very specious form of risk analysis.

Armed as they were with studies showing that the relatively high volatility of small stocks had historically been more than offset by commensurately higher returns, too many investors failed to ask themselves whether the riskiness of investing in small stocks had changed in a very fundamental sense. Of course, the very fact that so many institutions were clamoring aboard the small stock bandwagon in the early 1980s signaled that it had — that small stocks had become far less risky in the most important sense in which risk can be defined, namely career risk.

What is career risk? Career risk is the risk of making an investment that makes the people looking over your shoulder uncomfortable. If you were the head of a big pension fund or endowment and you had decided to plow a big chunk of it into small stocks in the 1940s, or the 1950s, or even as late the mid-1970s, you were taking on a lot of career risk. If, on the other hand, you decided to plow a lot of money into small stocks in 1983, you were taking on very little career risk, because a lot of your fellow pension or endowment officers were doing the same thing. It therefore comes as no surprise that small stocks hit a relative peak at precisely the moment in time when the career risk, as distinct from other forms of risk, inherent in them reached an unprecedentedly low level, namely in 1983.

Turning from bad examples to good examples of risk-taking, we can't possibly let you leave here tomorrow without paying proper homage to perhaps the most successful American endowment investor of all time, a gentleman by the name of Dean Mathey, Princeton, Class of 1912. [Worldwide: Keynes, Hilary's way: via derivatives, King College, commodities and futures!] By 1928, Mathey had assumed direct responsibility for Princeton's asset mix, and he took the incredibly bold step of liquidating Princeton's entire stock portfolio, notwithstanding the fact that high grade bonds yielded around 3% while the stock market had been compounding at the rate of 26% a year for 8 years. Talk about career risk: not only did Mathey face the prospect of a lifetime of reunion gatherings at which he would be ridiculed if the stock market continued moving higher, which of course it did for many months following his decision to get out of stocks, but he also ran the risk of jeopardizing his own livelihood, because at the age of 38 he was the CEO of one of America's largest trust companies (Empire State).

As some of you know, the punch line of the story is that, after saving Princeton millions by selling its stocks prior to the Crash of '29, Mathey had the courage to insist that Princeton reverse direction and jump back into the market in 1942, a time when the outcome of World War II remained very much in doubt and when the post-war viability of capitalism was none too clear. As Mathey himself put it in a famous letter to a fellow Princeton trustee, quote:

It's all very fine and well to stick our chests out and say, 'We pursue a very conservative policy,' and to feel self-righteous in uttering these trite words. But what is a true conservative policy? ... The only true test of conservatism is to be right in the future.

Obviously, no one can accurately and consistently predict the near- or even long-term direction of financial markets, and I would be the last to advocate investment strategies which in order to be successful presuppose a high degree of forecasting skill. On the other hand, I do believe rather strongly that you can substantially improve your odds of success by avoiding investments entailing a very low degree of career or reputational risk.

There are countless examples of investors flocking into investments that they perceived as relatively safe in the reputational or career risk sense, only to discover that career risk and returns are often inversely related. Two examples that come immediately to mind are IBM and Philip Morris. According to mandatory SEC filings of institutional holdings, in 1987 the stock that was held by more institutions than any other was IBM. Even though it traded at a rather rich \$175 a share, IBM was such a powerhouse that owning it was extremely comfortable, so comfortable in fact that, as you all know, over the subsequent six years the market value of IBM common stock declined by more than 75%. Although its hard to believe in light of how badly tobacco stocks have been beaten up in the last two years, as recently as the spring of 1992 Philip Morris held the title of the most popular stock among institutional investors, which was understandable given the huge amounts of cash its various businesses were throwing off. A comfortable stock if there ever was one, but hardly a riskless one in light of the subsequent decline of almost 50% in Philip Morris' stock price. As is almost always the case, when the reputational or career risk of investing in something is extraordinarily low, as it was with respect to IBM in 1987 or Philip Morris in 1992, the future returns on it get pushed way, way down — often into negative territory.

The converse is also true, of course: when the reputational or career risk of investing in something is extraordinarily high, so are the expected returns. Two examples of this phenomenon come to mind — natural gas stocks at the beginning of 1992, and gold stocks at the beginning of 1993. Both of these stock groups had underperformed the market for such a long period of time that no professional money manager worthy of the name would dare put them into a client's portfolio. Even money managers who admitted that these stock groups were cheap were afraid to buy them, because there were no obvious catalysts in sight that would cause them to stop underperforming the market. In hindsight, of course, we can see rather clearly that such a catalyst was indeed present in both cases — specifically, the fact that institutional investors who could no longer tolerate the pain of owning these stocks had finally finished bailing out of them. Those of you who follow the market know that natural gas stocks have been among the best performing stock groups since the beginning of 1992, as have gold stocks since the beginning of the 1993.

Interestingly, many of the folks who reduced rather than compounded their wealth by investing in Philip Morris at or close to its peak not so many moons ago did so not by buying Philip Morris shares directly but rather by buying them indirectly through the purchase of shares in a mutual fund stuffed full of Philip Morris that was introduced in a highly visible manner at around the time Philip Morris was peaking. I won't mention the mutual fund by name, but suffice it to say that it's managed by an individual who, while

admittedly wealthy and well-connected, may not be as skillful an investor as some of the people who put money into his fund supposed.

The simple fact is that, by buying comfortable stocks like Philip Morris and holding them until they became super-comfortable, this particular money manager became a super-comfortable choice himself, so much so that his assets under management began growing at a rate that far outstripped his capacity to identify profitable investment opportunities. As so often happens, people who entrusted their money to this person discovered that an investment entailing an abnormally low level of reputational or career risk proved to be extremely risky in other respects. Again, baseball supplies a useful parallel, in the form of a memorable line from the legendary manager Branch Rickey, who when asked to describe the key to his success as a manager, said, "I try to trade players a year too early rather than a year too late."

Die-hard baseball fans among you know that the only recorded example of Rickey having failed in this endeavor was a pitcher named Billy Loes. When asked by a reporter why he flubbed a ground ball that had been hit back to the pitcher's mound, Loes snapped back: "Give me a break — I lost it in the sun." Loes was also the fellow who committed perhaps the most memorable balk in baseball history by letting the ball squirt from his hand during the start-up of his windup in a particularly crucial World Series game. When asked after the game what had happened, Loes replied matter of factly: "Guess there was too much spit on it." At least Loes was honest about his cheating. The very successful manager Earl Weaver once went out to the mound to comfort a pitcher who was getting hit pretty badly and, according to the pitcher, whispered into his ear: "If you know how to cheat, start now."

Cheating may be a viable short-term strategy in baseball, but it tends not to work very well in financial markets, unless the type of cheating one has in mind is to break some of the behavioral norms that we've been discussing here today, including especially the norm of looking at risk as something to be avoided rather than exploited. As I've tried to suggest, this natural human tendency to favor comfort over potential profit is one of the chief reasons why almost everything in the capital markets tends to be cyclical: something shows a bit of promise, whether it's an individual company or a portfolio of companies assembled by a given money manager or even a whole country like the many emerging markets that were so much in favor at the end of last year, and people yank their money out of investments that are giving them indigestion and stuff it into the one that has the brightest future, as measured of course by its recent performance.

The problem with this approach is obvious: like cheating in baseball, it can indeed work very well over the short term, but it can be disastrous over the long term, because you can never know for sure when the supply of fresh capital pouring into a hot company, or a hot style of investing, or a hot country, is going to change direction. The only thing you can know for sure is that the flow of funds into what appear to be these sure winners will eventually be reversed, and when it happens investors who were smart enough and patient enough to keep some resources in reserve will be able to sweep onto the playing

field and make investments whose probable payoffs are vastly superior to those of investments made when the game was in full swing.

The baseball fans among you who've been paying close attention no doubt recognize that the investment strategy I've just described is strikingly similar to the strategy used by most winning teams in baseball's so-called modern era — namely, effective relief pitching. Because it so aptly illustrates the points I've tried to make tonight about calculated risk-taking, I thought I would share with you a gem of a story that George Will relates in his superb book about baseball entitled "Men at Work".

One of baseball's impenetrable mysteries [Will writes] is the question of who invented the concept of relief pitching. A baseball writer named Bill James thinks he has the answer: Napoleon. No joke. 'Napoleon,' James writes, 'believed that every battle tended, for reasons of its own, to resolve itself into immobile, equal positions. Accordingly, on the day of a battle, he would take two or three regiments of crack troops, and sequester them some distance from the battle, eating and sleeping and trying to stay comfortable. Over the course of a day or several days, the troops in the field would take positions and lose them and retake them and relapse them, growing ever more weary, their provisions in shorter and shorter supply, and their positions ever more and more inflexible. Finally, at a key moment in the battle, with everyone else in the field barely able to stand, Napoleon would release into the fray a few hundred fresh and alert troops, riding fresh horses and with every piece of equipment in good repair, attacking the enemy at his most vulnerable spot. He did this many times, and with devastating effect. And if that's not relief pitching [James concludes], I don't know what is.

I will simply add that if the Napoleonic theory of relief pitching isn't also a perfect definition of contrarian investing, I don't know what is. I admit, it takes courage to remain above the fray when other investors are already crowding on to the field, and especially when some have begun scoring some minor victories, but your chances of avoiding a major defeat and perhaps earning a major victory can be much improved if, like Bob Gibson, you favor calculated risk-taking over excessive risk avoidance.

I've already used up a decent chunk of my allotted time, and I want to leave at least some of it for discussion, but I know from past experience at these workshops that the first question I invariably get asked is something along the following lines: "What you said is all very fine and well, but can you tell us specifically how the principles you've outlined might be applied today? Which areas look attractive to you, and which would you avoid?" Let me try to anticipate this question by reviewing very briefly some of my thoughts on the current investment climate, starting with an admittedly hindsight view of the two most recent and very glaring examples of assets or strategies that proved far riskier than many people assumed precisely because they had become so comfortable. The two examples I have in mind, of course, are emerging markets and so-called hedge fund investing..

As with small stocks in 1983, both of these areas were so much in vogue by the end of last year that their expected returns had gotten pushed way, way down. I know that Bob

Schulz of The Common Fund is going to be here tomorrow to talk about hedge funds, so I'm going to bite my tongue on that subject except to say two things: one, I think the term hedge fund has become so overused that it has lost all meaning; and two, despite the fact that some of the players who had crowded onto the playing field in recent years have now been sidelined, I fear that too many inexperienced players remain on the field to make hedge fund investing the lay-up that it was in the early part of this decade. As I'm sure Bob will discuss, the macroeconomic environment for the particular form of hedge fund investing practiced by such luminaries as George Soros and Michael Steinhardt could not have been more favorable than it was in the early 1990s, and I would not want to wager much on such a favorable environment recurring anytime soon.

Having said this, I do rather fancy the particular form of hedge fund investing or rather I should say hedged investing known as capital structure arbitrage. How many of you have direct experience with managers engaged in capital structure arbitrage? Good: since I'm hoping to use this strategy in our own investment program I think I'll say absolutely nothing about it. Actually, I'd be pleased to talk about it during the Q&A, but let me first follow up on my promise to say a word or two about emerging markets and one other strategy that commands a lot of attention these days, so-called long/short or market neutral investing.

With respect to emerging markets, I think that they continue to have a lot of potential, but only if you play the game according to the rules I outlined earlier. In hindsight, we can now see that the reason so many people lost so much money investing in emerging markets earlier this year is because they weren't taking enough career risk: the ultimate owners of the money — pension funds, endowments and the like — didn't take enough career risk because they plowed money into an area that had already become exceedingly comfortable; and the managers they funded didn't take enough career risk because they in turn plowed most of the money pouring into their hands into a relatively small number of already overvalued issues, rather than parking it in securities not included in their performance benchmarks, or God forbid, in cash.

Is it too late to make lots of money investing in emerging markets? Unfortunately, the answer is — it depends. If you're going to invest in emerging markets through a so-called emerging markets specialist who lacks the backbone or financial incentives to take a lot of career risk, I doubt whether the game will be worth the candle. Although emerging markets are anything but monolithic, taken as a group much of the undervaluation that attracted so much money to them in the early part of the decade has been arbitrated away, and as with any investment that is superficially attractive because it offers the opportunity for rapid growth, as distinct from a compellingly cheap price, I think investor expectations of the probable growth rates of many developing market economies may prove excessively optimistic. So I'm not very bullish on the idea of investing in emerging markets on a passive, buy-and-hold basis, at least not over the relatively long time horizons that you and your investment committees ought to manage against. Over the short term, I think emerging markets could deliver a nice pop, especially emerging market bonds, but I would be the first to concede that no one can accurately predict the near-term direction of financial markets, least of all me.

However, if instead of buying into emerging markets on a passive, buy-and-hold basis, you or the managers to whom you've delegated such responsibility are going to invest in emerging markets only when a really fat pitch comes floating across the plate, then obviously you can and probably will make a lot of money. What I've just said may sound tautological, and it is. But it also contradicts flatly the way many institutions have approached emerging markets — namely as a distinct asset class. To my way of thinking, emerging markets are not a distinct asset class, any more than say European or Japanese or, for that matter, American equities are, and I am therefore uncomfortable with any emerging markets exposure whatsoever unless it is the product of someone, somewhere making informed judgments about the valuation of each and every emerging markets issue that is held relative to competing alternatives traded not just in other emerging markets but in developed markets also.

Of course, given how highly specialized the money management business has become, there are very few managers that are willing to shift money back and forth between developed and emerging markets, and even fewer with a proven ability to do so in a timely manner. A lot of foreign stock managers boast about how much value they've added in recent years by investing a portion of their EAFE-oriented accounts in emerging markets securities, but the truth is that most of them shifted funds into emerging markets for the wrong reason: they did so because both the European economy and the Japanese economy were shrinking rather than growing, and the top-down, growth-oriented approaches that the vast majority of foreign stock managers employ left them no choice but to engage in what some cynics have dubbed "emerging markets creep." Hence, while it is mathematically true that these managers added value by shifting funds into emerging markets, it's not clear to me that their willingness to do so entailed the assumption of the kind of career risk that investors get paid to bear. In fact, it may have entailed the opposite: a stubborn determination to avoid taking perhaps the biggest career risk that a modern money manager can take — changing its investment approach in response to changing market conditions, or what the consultants refer to as "changing one's stripes."

This issue of whether or not managers should be penalized for changing their stripes is actually my lead-in to the other asset allocation opportunity that I wanted to discuss during my prepared remarks, so-called long/short or market neutral strategies, especially as applied to publicly traded stocks. Although long/short or market neutral strategies are hardly a recent invention, there is still an incredible imbalance between the amount of effort devoted to outperforming market averages by buying undervalued issues and the amount of effort devoted to outperforming market averages by selling overvalued ones. At last count, more than \$4 trillion dollars was committed to long-only strategies of one sort or another within the U.S. stock market alone, while only about 1% of this amount — or \$4 billion — was committed to short selling or market neutral strategies.

My own view is that this incredible imbalance between the vast numbers of people who prefer to play the game with one hand tied behind their back and those who recognize that it's easier to play with two hands is going to disappear fairly quickly, not only because institutions are relying increasingly on so-called long/short strategies but because



even the unwashed masses are getting into the game, unwittingly or not. As some of you know, Fidelity has sought shareholder approval to permit most of its equity funds to engage in short selling, and the boost to overall market efficiency that even small increases in the amount of capital committed to short selling will provide will make it that much harder for conventional long-only strategies to beat market averages net of fees and trading costs.

Having telegraphed to you my own belief that two-armed ballplayers are more effective than the one-armed variety, I owe it to you to explain precisely why I see a connection between the opportunities that long/short strategies entail and the perils posed by a mindset that is widely prevalent in the money management business, namely that one should avoid like the plague money managers who, quote-unquote, change their stripes. However superficially appealing this mindset might seem, it unfortunately contradicts flatly one ugly fact: money management is not only the most dynamic industry there is, it is actually the source or root cause of most major changes in every other part of the for-profit sector of the economy, in the sense that all for-profit enterprises are ultimately subordinate to the disciplinary powers of the capital markets. In light of the profound impact that computers and computer-based money management techniques have had on the internal dynamics of the U.S. stock and bond markets in particular, I think it is unwise if not downright insane to rely on managers who do not, quote-unquote, "change their stripes."

The simple fact is, many of the techniques that have historically produced satisfactory excess returns net of fees and trading costs no longer do so, and many techniques that could not possibly have produced satisfactory results prior to the advent of cheap computers and the rapid information flows that computerization has spawned may represent the only way to outperform our increasingly efficient domestic stock and bond markets on an unleveraged basis. The most obvious examples of outdated strategies that come to mind are simple low P/E or low price-to-book approaches to the management of large capitalization domestic equities, or conventional maturity or duration-driven approaches to bond portfolio management. I think simple value-based approaches to foreign stock investing still have many productive years ahead of them, partly for the reasons we discussed earlier — the tendency of foreign investors to focus on growth rather than value — but I don't hold out much hope for them in our own stock market and I don't think that the maturity or duration-based approaches that enabled many domestic bond managers to rack up good records during the last decade or so are going to work very well in coming years.

So my closing comment is that the same principles that work so well when applied to the all-important issue of asset allocation — the idea that you should favor calculated risk-taking over excessive risk avoidance — also work well when applied to the problem of choosing money managers. The comfortable thing is to rely on managers whose techniques have worked well in the past; the more profitable course is to rely on managers whose techniques are geared specifically to the opportunity set with which managers will be confronted in the future. By definition, the techniques that will work

best in coming years are today untested under real-live battle conditions, because the opportunity set they are designed to exploit has not yet fully manifested itself.

Needless to say, there aren't many trustees that are willing to fund untested strategies, regardless of how intuitively appealing they are or how much experience the folks who want to put them to work have made for their clients. This is why The Common Fund plays such an essential role in higher education, and — quite frankly — it was why I made the unbelievably foolish decision to leave a cushy partnership at a very profitable money management firm to help build a common fund for foundations. As I have often said, even in the presence of my friends who work there or serve on its board, The Common Fund is like those wonderful hot dogs you get at the ballpark: it tastes good but you don't want to see it being made. By favoring calculated risk-taking over excessive risk avoidance — especially with respect to its use of innovative managers and strategies — The Common Fund has made a lot of money for its member schools over the years, albeit in a manner that would have rattled many trustees if they had wandered into the factory and examined how the hot dogs they found so tasty were actually being made. With that final iteration of my thesis for today, and that final and admittedly strained allusion to baseball, I think I'll hush up. Thank you.