

Navigating a VUCA World

Actively Speaking Podcast Transcript

Today's complex markets cannot be understood by solely relying on simple neo-classical economic models. In order to fully appreciate the risks and opportunities in a high VUCA (Volatility, Uncertainty, Complexity and Ambiguity) environment, Epoch CEO Philipp Hensler sat down with Portfolio Manager Steve Bleiberg to discuss how asset managers must adopt a more mindful approach in order to adapt to unexpected events.

Q1) What does VUCA mean and where does it come from?

VUCA stands for Volatility, Uncertainty, Complexity and Ambiguity and basically describes an environment that is unpredictable. The term was first introduced by the U.S. military after the fall of the Iron Curtain. At the time, the U.S. military saw a shift from a bi-polar threat scenario (where you had only two opposing systems, one supported by the Soviet Union and the other supported by the U.S.) to a multi-polar system where you suddenly had many more threats from other actors to consider. The result was that you moved from a rather stable framework to a situation that was extremely fragile and characterized by VUCA.

Q2) The current COVID-19 period has brought quite a bit of uncertainty. While investing theorists have come up with a number of ways to describe how markets work, with Modern Portfolio Theory being the most famous example, how do periods like this showcase MPT's shortcomings and what do they imply?

You are right, Steve, when the markets misbehave, the shortcomings of neo-classical economic theory (and Modern Portfolio Theory as a derivative of it) become obvious.

I've always thought that the elegance of Modern Portfolio Theory is in its simplicity. In order for a relatively simple model to accurately describe a rather complex system (like financial markets), you have to make some simplifying assumptions. Let me give you some examples:

- MPT assumes a normative worldview, which means it describes the world how it is supposed to be, not what it actually is. For instance, it assumes that all market participants have the same stable preferences, are perfectly rational at all times and are constantly optimizing their utility function. We know from the work that behavioral scientists have done that none of the above accurately describes human behavior.
- Furthermore, it assumes that history is a good guide for the future and that historic patterns can be linearly extrapolated into the future. While I agree that history can and should inform our decision making process, it is not necessarily a good predictor of the future.
- And finally, MPT assumes that financial market theory is a hard science (similar to chemistry or physics) where we can describe the relationship between the independent and dependent variables with mathematical precision. Personally, I would argue that financial markets are social systems, where the interactions between humans matter a great deal. These interactions cannot be described with a mathematical model alone.

Q3) These models can be useful in normal market environments, but how do they work in extreme environments like the GFC or the last two months?

Great question, Steve. In extreme environments you can't solely rely on what has worked in the past. Many of the models that worked perfectly well during normal market circumstances failed us when we needed them the most. So, we know that these models are not terribly helpful when the markets misbehave, but what is probably even more astonishing is the fact that although people realize that the models don't work that well all the time, they continue to be unconditionally committed to them – a phenomenon I would describe as “model blindness.” In other words, they dismiss information that lies outside the model parameters as irrelevant and, as a consequence, no learning takes place.

As part of an academic project, I studied investor behavior during times of market distress. Specifically, I asked investors about their experience during the 2009 global financial crisis. Everybody I interviewed told me that all the models they had been using were ineffective, that they needed new thinking and required a radical departure from the past. However, when I asked them what they had done differently during the crisis, I was surprised to learn that they themselves didn't see the need for change at all. As a matter of fact, 80% of advisors in my study continued to rely on a rules-based-approach that is centered around neo-classical economic theory.

While this majority of investors were steadfast in their beliefs in MPT, there was a small group who showed a heightened degree of contextual sensitivity, and as a result, did much better than their peers. They had the following characteristics: 1st: They had a high degree of alertness/awareness, 2nd: they were present moment focused, and 3rd: they were non-judgemental when new information emerged. What is interesting is that these are the same characteristics that describe a particular form of “Mindfulness.”

Q4) What are some of the benefits we can get from that mindfulness?

I really think it can help us with making decisions under uncertain conditions.

Q5) Can you elaborate on that?

As I mentioned, neo-classical economic theory assumes we are all universally rational and continuously optimize our utility function. Well, it seems obvious that we can only optimize an outcome if all future states of the world are known. Unfortunately, that is (almost) never the case. In 1956, Herbert Simon introduced us to the concept of “Bounded Rationality.” Bounded Rationality suggests that people are typically very good in making rational choices when the outcomes are known. So for example, Steve, if I were to give you the choice between receiving \$1 and \$2, I am pretty sure you would make the right choice and make the decision to pick the \$2 over \$1. But when it comes to decision making under uncertain conditions, heuristic decision making (using simple rules of thumb) is as efficient as more elaborate or scientific decision making models. The huge advantage of heuristic decision making is that it doesn't require perfect information, can be done faster and is contextually sensitive. The two most

powerful heuristics that many of us use on a daily basis, are “follow the majority” and “follow the successful.”

Q6) Can you give us a real world example of that?

Sure. Let’s say my wife and I are planning to go out to dinner (admittedly a bit of an outrageous assumption during these difficult times). How do we pick the right restaurant? Well, we could go the scientific route and download all available details on all the restaurants in town, enter our preferences and constraints into an excel spreadsheet and then run an optimization to determine what the best restaurant is. Or, I can simply take my Michelin guide, check what restaurants have the highest ratings and go there (which would be an example of “following the successful”). Another approach could be to just go out and see which restaurants are full of people and try to get a table there (which is an example of “following the majority”).

As you can see, if speed is of the essence, applying simple heuristics is a very effective method and typically yields more than satisfactory results, which makes it a viable tool for when financial markets are becoming VUCA. When you are faced with a market meltdown, you neither have the time nor the necessary data to make perfectly informed decisions. What you need to do is make “biologically rational” choices that guarantee your survival. If you want to thrive in our industry, you must focus on becoming the most adaptable firm and not necessarily the most efficient one.

Q7) How do we use these concepts in asset management?

There is some interesting academic research being done on so called High Reliability Organizations (HROs), which I think is quite applicable to asset management. Think of aircraft carriers or nuclear power plants as examples of such HROs. They operate in a very stable environment for a very long time until something unexpected happens, which requires them to adapt to a new situation very quickly and transcend beyond (historically very successful) operating models. The research shows that these HRO’s have 5 traits that allow them to respond to a VUCA environment in an effective way. If you don’t mind, let me elaborate on those 5 traits a bit:

First, these HROs are “pre-occupied with failure”

For our firm, this means we need to be humble. Overconfidence is deadly in our industry. We have to accept that we can’t predict every conceivable outcome. We also need to have some “slack” built into our operating model that will allow us to react to the unexpected. Without any dry powder, we won’t be able to respond to opportunities and/or challenges that invariably get presented to us in market dislocations.

Second, they have a “reluctance to simplify”

At Epoch, we are trying to be a “learn it all” firm and not a “know it all” firm. We need to have a high degree of intellectual curiosity especially about the things we’ve never seen before or events that lie outside our mental models. Challenging one’s mind is a necessary condition for a successful asset manager.

Third, HROs have a “high sensitivity to operations”

This is a very simple, but an incredibly important, concept. You continuously have to review your operating model and make sure there aren't any blind spots. It is so easy to assume that everything is okay, simply because we haven't seen any breakdowns. You need to continuously stress test your operating model and make sure you avoid complacency at all costs.

Fourth, they display a “strong commitment to resilience”

Let's face it, failure is inevitable in our industry. Nobody gets through a career in asset management without failing. That is not necessarily a problem as long as you see failure as a learning moment. I'm convinced that's why culture and diversity are so critical for an asset management firm. You become more resilient if you have people with cognitive diversity around you that can provide a different vantage point and help you make sense of an unfamiliar situation.

And finally, HROs show a “deference to expertise”

As the leader of an asset management firm, this point is particularly dear to my heart. Many asset management firms have a very rigid, vertical hierarchy, which lengthens the decision making process. Here at Epoch, we are trying to create as flat a hierarchy as possible and delegate decision making authority to the people in the frontlines so they can make decisions quickly and in a timely fashion. This only happens if you create a culture of collaboration where people feel safe to make those decisions.

So, I think the point I'm trying to make is that in order to win in asset management you need a whole-brain approach. Using the left (which is the logical, mathematical side) and the right (which is the empathetic, emotional side) of one's brain, one will be better prepared to anticipate and deal with unexpected market fluctuations and achieve better results for one's clients.

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