Cooperation, Not Competition, Is the Road to Success

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Many institutions spend too much time analyzing the markets and not enough time understanding their own unique investment circumstances. Focusing on their unique investment preferences might help them avoid the perils of herd behavior and discover opportunities for market cooperation, rather than zero-sum competition. Over the long run, this could improve both market diversification and investment outcomes.

Intelligent asset allocation requires a blend of self-knowledge and market knowledge. Self-knowledge requires a detailed understanding of all the ways in which you are different from other investors. This includes such parameters as return objective, risk tolerance, time horizon, spending requirements, liability profile, liquidity preferences, appetite for complexity, investment constraints, and more. We can group all these parameters together as “preferences.”

Market knowledge is more appropriately called a market “view,” since genuine knowledge is famously elusive. Here the key ingredients are return, risk, and valuation across a wide range of asset classes.

Developing the right market view is arguably the most competitive game in the world. Every player wants more information, faster, and with greater insight. The potential rewards are immense, but the likelihood of winning is small. Developing a nuanced appreciation of your own investment preferences lays the foundation for cooperation, not competition. Here the likelihood of success is greater, since success no longer requires beating the competition.

Competition makes financial markets both more efficient and less efficient. On the one hand, competition removes the most obvious free lunches, the opportunities for return without risk. But competition also breeds imitation, since investors tend to mimic what they see as others’ successful strategies. And imitation leads to a kind of herd behavior that harms the markets in aggregate and also harms individual market participants.

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Markets are harmed because herd behavior produces crowded trades, bubbles and panics. Investors are harmed because herd behavior leads them to buy high and sell low.

Cooperation is an essential antidote to the darker consequences of competition. And cooperation requires a genuinely heterogeneous investment community, where investors have different preferences, and they embrace those differences.

Most investment behavior has a sandwich construction, with a thick slice of cooperation enclosed between two layers of competition. Imagine two equity managers, one pursuing a growth/momentum strategy while the other pursues a value/contrarian strategy. Both managers want to beat the market and to beat each other, so the top layer of the investment sandwich is a crusty slice of competition. Underneath that slice is a middle layer where the differing strategies create opportunities for cooperation. If the stock of a mature growth company begins to show deteriorating fundamentals and poor price action, then the growth manager might sell the stock to the value manager. In this transaction, both managers get what they want. And then competition returns in the bottom layer, since both managers want the best price when they trade.

This cooperation-on-competition sandwich is also present in the asset allocation process. The chief investment officer of a large institution wants more return, less risk, lower expenses, and he wants to outperform his peers. This is the competitive top layer. The bottom layer, where individual trades take place, is also competitive, since everyone wants the best price.

The middle layer is where differences in preferences create room for cooperation. When an overfunded pension plan that wants to “get out of the pension business” sells equities to a university endowment that hopes to be in the education business forever, both parties to the transaction get what they want.
The cooperative slice in the sandwich gets thinner and thinner as the trading counter-parties develop more similar preferences. If the only difference between the buyer and the seller is a difference in views, then they are playing a purely competitive game in which only one player can win.

Institutional investors constantly compare their performance to that of other members of their “peer group.” The competition keeps everyone on their toes, but it can also lead to “peer group syndrome,” in which investors follow in the footsteps of other successful investors without paying enough attention to vital differences in preferences and basic investment circumstances. If you adopted “the Yale model” ten years after Yale did, and if your liquidity needs were greater than Yale’s, then you were heading into dangerous territory.

The key to asset allocation success is to take advantage of your uniqueness, that is, appreciate the many ways in which your preferences might be different from those of your “peers.” This takes you out of the zero-sum competition into a cooperative setting where success does not require victory. Better to make your own investment sandwich than to covet someone else’s.
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