

The Corporation, the Psychopath, and Volatility Investing

A speculative discussion on the behavioural shortcomings of limited liability companies, and the implications for the success of their investment strategies and businesses.

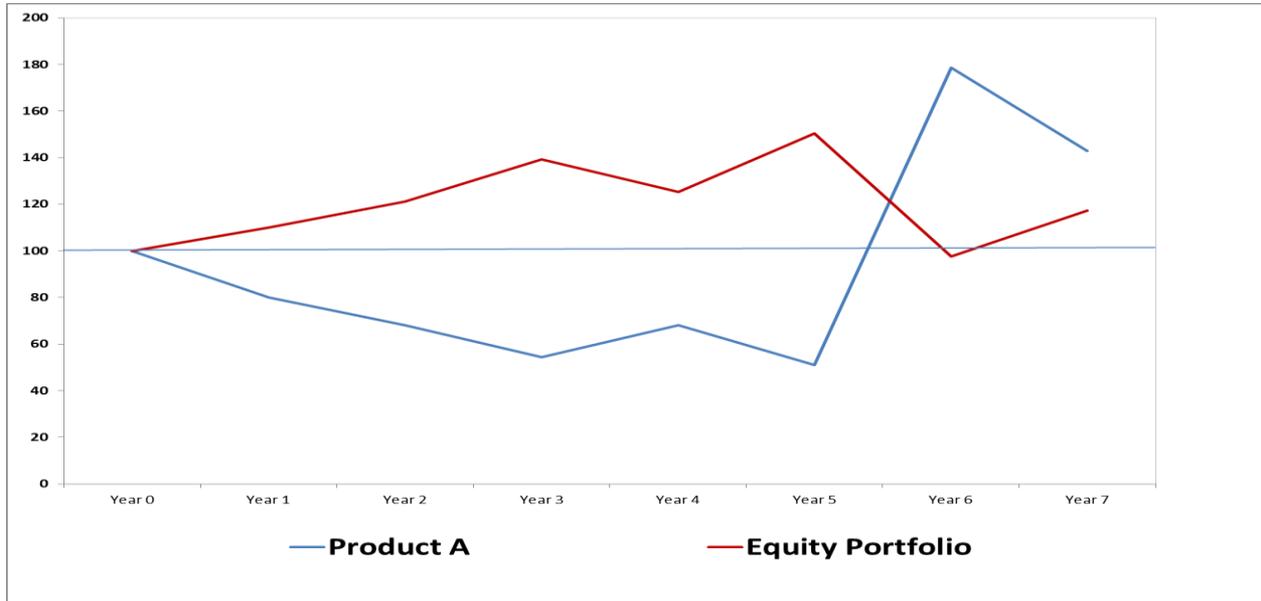
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Question 1

PowerVote



Would you invest in Product A as a diversifier/hedge against your equity portfolio?



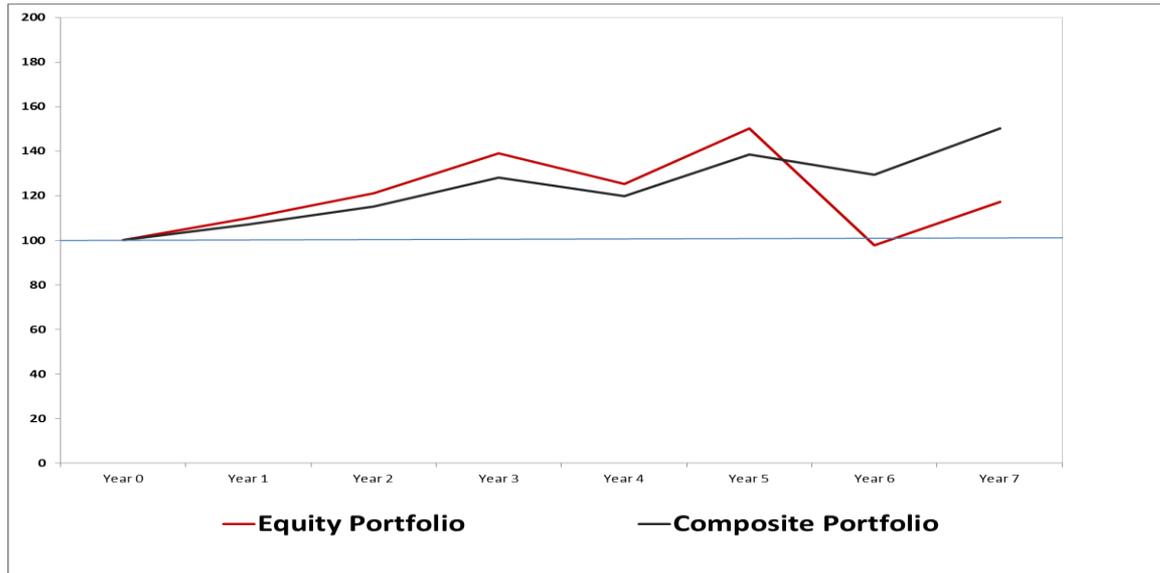
A	Yes
B	No

Question 2

PowerVote



Which would you rather invest in?



A Composite Portfolio

B Equity Portfolio

Why did so many banking and investment firms, full of intelligent and educated investment professionals...

...fail to hedge their portfolios in 2007/2008...?

Investment firms had access to negatively-correlated, negative-carry, but highly-convex, positive expected return strategies.

Yet most failed to invest, even though a substantial proportion investigated such strategies.

There were many who had intentions to invest...but didn't.

**A quote from a prospect for the 36
South Black Swan fund...**



From November 2007...(paraphrased)

“There’s no point in paying for insurance.

If it all falls apart, we’ll all be in it together”

Within 14 months - this person was out of a job, and the (large) business he worked for had closed down.

What is this reason for this discussion?



- Well-run strategies in long volatility, and tail risk have real portfolio diversification, and protection benefits.
- But they have proved difficult to both invest in, and hold.
- This discussion is a speculation on what might be one of the reasons...

What I will talk about...

1. The history of corporations, limited liability companies.
2. The corporation as a “person”.
3. Why corporations might have a “psychology”.
4. Bias, that investors are subject to...companies might be as well?
5. The way that investment companies interact with investment strategies that are negative carry, but positive expected return.
6. What might be done with this information?

The History of Corporations

History of the Corporation



15th century, English law had awarded limited liability to monastic communities and trade guilds with commonly held property.

17th century, joint stock charters were awarded by the crown to monopolies such as the East India Company.

The world's first modern limited liability law was enacted by the state of New York in 1811.

1844 England Joint Stock Companies Act - 1855 England Limited Liability Act

1886 USA Supreme Court. Chief Justice Morrison R. Waite ruled that corporations, being legal “persons” have the same rights as human beings, based on the Fourteenth Amendment to the United States Constitution.

**What if “the company” being a legal person,
acts similarly to an actual person?**

The Corporation as a “Person”

The Corporation (the movie)

2003 Canadian documentary film written by University of British Columbia law professor Joel Bakan. Became a book “The Corporation: The Pathological Pursuit of Profit and Power”.

Directed by Mark Achbar and Jennifer Abbott.

The documentary examines the modern-day corporation.

The principal thesis is that limited liability companies, being legally defined as “persons”, have behaved as such, and have the psychological profile of a psychopath.

A by-product of the success of the limited liability companies has been a raft of environmental and social disasters.



the Corporation
a film by Mark Achbar, Jennifer Abbott & Joel Bakan

Characteristics of a psychopath...

- Lack of empathy (uncaring)
- Lack of fear
- Irresponsibility, (blame others, externalities)
- Manipulative (“conning others for personal profit or pleasure” World Health Organization definition)
- Overconfidence (“grandiose sense of self-worth” Cleckley 1941)
- Impulsive (narrowing of attention, ignoring second, third order effects)
- Selfishness
- Short term analytical horizon (inability to plan for the future, a lack of realistic long term goals)
- Violence (could be aggressive litigation, sometimes illegal covert actions)

<http://www.psychologytoday.com/blog/mindmelding/201301/what-is-psychopath-0>

Why corporations might have a psychology...

Corporations are self-organizing entities.

<http://en.wikipedia.org/wiki/Self-organization>

Corporations exhibit “collective intelligence”

http://en.wikipedia.org/wiki/Collective_intelligence

“Collective intelligence is shared or group intelligence that emerges from the collaboration, collective efforts, and competition of many individuals and appears in consensus decision making.”

http://en.wikipedia.org/wiki/Collective_intelligence

Only as intelligent as the weighted median of the education and experience of the employees that are in executive roles.

Why do we join companies as employees?

Why don't all of us go out and earn a living on our own?

Why are we prepared to forgo personal belief systems in order to be a company employee?

Herding

W.D. Hamilton (1971) "Geometry For The Selfish Herd"... "asserted that each individual group member reduces the danger to itself by moving as close as possible to the centre of the fleeing group.

Thus the herd appears as a unit in moving together, but its function emerges from the uncoordinated behaviour of self-serving individuals".

http://en.wikipedia.org/wiki/Herd_behavior

Herding

The company (as a herd) allows us access to economic resources...enabling survival, and hopefully prosperity.

The company (as a herd) protects us against the uncertainties of being self-employed.

The company (as a herd) protects us against both the economic cycle, and exogenous events.

Swarming Behaviour

In 1986, Craig Reynolds developed the “boids” computer program, which simulates swarm behaviour. There were three basic rules.

1. **Move in the same direction as your neighbours**
2. **Remain close to your neighbours**
3. **Avoid collisions with your neighbours**



Put this in the context of the way we interact with others in a corporate environment.

A typical corporate environment might have a core group that acts as a swarm, the swarm being directed by management.

Management in this context directs the swarm as a **virtual predator**, a result of management’s ability to terminate employment.

http://en.wikipedia.org/wiki/Swarm_behaviour

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Herding may limit relative risks, but may boost absolute risk...

Why might the Corporation be a virtual psychopath?

Agency costs...the zero-cost option...



http://en.wikipedia.org/wiki/Agency_cost

Investment biases affect executives within investment firms at an individual level.

Do they affect investment firms as an aggregate behaviour of the herd?

Some investment biases...

- Loss aversion (myopic loss aversion – limited horizon, feeling losses 2x profits)
- Incentive bias (investing to one's bonus window)
- Herd mentality (protection from predators)
- Recency bias (Gambler's fallacy), projection bias, anchoring
- Ownership bias/sunk cost effect
- Fear of future regret
- Confirmation bias
- Revenge trading

Investment firms' interaction with negative carry, positive expected return strategies...

Negative carry, positive expected return strategies...how bias affects firms...

- **Loss aversion (myopic loss aversion).**
- **Incentive bias.**
- **Recency bias (gambler's fallacy), projection bias, anchoring.**
- **Fear of future regret.**

Myopic loss aversion and the firm...

Periodic performance reporting creates a series of “emotional” events for the investment firm as an artificial person. The artificial person’s “brain” is the investment team who react in aggregate to these performance events.

Negative events are “felt” twice that of positive events. The horizon is limited to the performance recognition increment...the annual bonus cycle.

Myopic loss aversion and the firm...

The investment team will tend to act as a swarm/herd, but the swarm/herd's behaviour is always being modified by the actual, or contingent presence of virtual predators.

The virtual predator might be the CIO, or management that supervises the investment team. It might also be clients, maybe in turn acting as a herd.



The hypothesis behind this presentation...

That as a result of aggregate investment bias, an investment firm will tend to negatively modify the investing performance of its executives.

So what can be done with this thesis, if it is valid?

To get a robust investment performance through the entirety of the investment cycle, it is not enough to employ clever, experienced people.

The investment firm must be of a deliberate construction that allows/encourages clever people to be free to make, and implement the appropriate long term strategies.

Investment firms need a series of structures and policies to minimize the institutional biases that lead to adverse investing behaviour by the firm.

e.g. remuneration guidelines that reward preservation of capital proportionately against the generation of profits – in the long term.

Investors should demand this. And are starting to...

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Wikipedia across a range of topics including Herding, Swarms, Collective Intelligence, Agency Cost, Self Organisation

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