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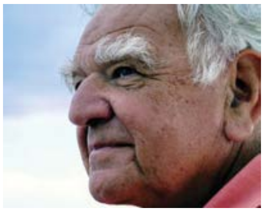
Being First Is Best: An Adventure Capitalist's Approach to Life and Investing, A Conversation with Dean LeBaron

Being First Is Best

An Adventure Capitalist's Approach to Life and Investing: A Conversation with Dean LeBaron

A self-described "adventure capitalist," Dean LeBaron is the founder and former chairman of Batterymarch Financial Management, recognized as one of the most innovative investment management firms in the industry. As an "investment futurist," LeBaron was one of the first to see the potential of quantitative investing, implementing computer-driven technology and modeling techniques at Batterymarch to systematically analyze data, trade, and manage investment portfolios. Under LeBaron's leadership, Batterymarch pioneered indexing as an investment strategy. An early adopter of a contrarian philosophy, LeBaron followed his own advice that "in the investment field, you should be where everyone else is not," leading Batterymarch to become one of the earliest (or first) institutional investors in the emerging markets of China, India, and Latin America. His interest and work in Russia resulted from an invitation from the government of President Mikhail Gorbachev to help privatize the Soviet Union's military industrial complex. With more than five decades of experience as an investment manager, LeBaron often has been the right man in the right place at the right time, following his maxim that "if the choice is limited to being best or being first, being first is often best."



Dean LeBaron, MBA

LeBaron traces his entrepreneurial spirit to growing up as the son of a country doctor who shared his joy of pushing the boundaries in small airplanes and other pursuits, who experimented with inventing a non-nicotine cigarette, and who became a self-taught student of statistics in order to conduct back-therapy studies on troops during World War II. This, plus the private-school educational opportunities provided by his parents, eventually led him to Harvard University, where he earned a bachelor's degree in 1955. While subsequently working as a management trainee recruiter for Norton Company, a manufacturer in western Massachusetts, LeBaron paid a business visit to the Harvard Business School and—impressed by the students' motivation, intelligence, and ability to work in a variety of environments—applied for admission.

Following his graduation as a Baker Scholar (awarded to the top five percent of the graduating MBA class) from the Harvard Business School in 1960, LeBaron worked as an analyst at the investment firm of F. S. Moseley & Company in Boston, specializing in electronics companies. He then became director of research at Keystone Investment Management, where he managed the Keystone Custodian Growth Fund during the early heyday of growth funds. During this time he became interested in cutting-edge economic theories about portfolio management. One insight that captured his imagination was that a type of complexity science based on computer models could be applied to portfolios to spread risk across many stocks. In 1969, he launched Batterymarch to apply concepts such as these to real-world investing, serving as chairman until selling the firm to Legg Mason in 1995.

Since then, LeBaron has continued to explore and experiment with new technologies and financial innovations. He currently serves as the chairman of Wordworks Inc. and virtualquest.company. His website, www.deanlebaron.com, provides a platform for his latest thoughts, experiments, articles, speeches, and video commentaries.

LeBaron is the author of numerous articles and books, most recently *Mao, Marx, and the Market*, an account of his investment and personal experiences in China and the former Soviet Union following the demise of their command economies. He also has published several e-books, including *Why I'm (Still) Investing in China*. LeBaron earned his CFA charter in 1967. Among his many awards, in 2001 he was named the seventh recipient of the CFA Institute's highest honor, the Award for Professional Excellence. This award, first presented in 1991 to Sir John Templeton, was established to honor members of the investment profession "whose exemplary achievement, excellence of practice, and true leadership have inspired and reflected honor" upon the profession.

In June 2013, LeBaron spoke with members of the *Journal of Investment Consulting* Editorial Advisory Board about his reasons for going into investment management, his views on past, present, and future investment strategies, and his philosophy that being first is best—and also more fun. Taking part in the discussion were Margaret Towle, PhD, CPWA®, the *Journal* editor-in-chief; Edward Baker, The Cambridge Strategy; Ludwig Chincarini, PhD, University of San Francisco and IndexIQ; Michael Dieschbourg, CIMA®, Broadmark Asset Management; Geoffrey Gerber, PhD, TWIN Capital Management; and Meir Statman, PhD, Santa Clara University. This interview is the fourteenth in the *Journal*'s Masters Series, which presents topical discussions with leading experts and visionaries in finance, economics, and investments.

Margaret Towle: We're really pleased to have you take part in our Masters series. As we've noted, you have some great information about your background on your website. However, we'd like to hear from you directly as to what you believe were the major factors that helped to shape your career and bring you to where you are today.

Dean LeBaron: Well, let me start in terms of where I am today. Essentially, I have been out of active money management—meaning managing money for other people—for the past ten or fifteen years. I now manage money for myself, doing the same foolish things that I always did, running the odd markets and odd strategies, and trying to do different types of things. So I've continued down the path for uniqueness. However, since I'm unlikely to fire myself, I have a little bit more freedom than I used to—although that never made too much difference. I think I might start at the beginning and talk about why I went into investment management in the first place.

When I graduated from the Harvard Business School (in 1960), the appropriate thing to do was to be the man in the gray flannel suit who aspired to be an assistant plant manager for General Motors someplace. Only about two or three people in my graduating class were going into what was then referred to as "Wall Street." When I became an analyst, the sign on my door said that I was in the statistical department. Ultimately, I decided on Wall Street because a professor of mine, Dick Vancil,[1] looked at me and said: "Dean, most people in the investment business fail more than half the time. They do so publicly with large amounts of money, and they have to go back and start over again. Most people don't have a personality that will stand that type of assault, but I think you do, and you will succeed better than half the time." There was some merit to that, I thought, and the merit was that what he really was saying was you had to buck the crowd, and if you did that in the field of investment management, you could be recognized and given responsibility at a fairly young age. There was very little competition because very few people were going into that field. Most people were, as I said, going to General Motors and the like.

I then moved to the point of view that in investment management you should match the investment style to your own personal psyche. So if someone said to me, "You should be a momentum manager or get into super-hot stocks," I knew that was not for me. Although I was an expert on fiberglass boats at one time, believe it or not, I'm a bottom fisher, and psychologically that suits me in many things that I do. I look for the questions that are not being asked, not so much taking the opposite of questions that are asked and coming up with the negative, but what questions literally are not being asked. That really characterizes my investment style. I continue to do that today, looking for the things that are just not covered by other people. I look in the holes. I'm attracted to dirt and places where there's dirty data, not clean data. I'm attracted to the areas where other people fear to tread because of potential criticism. Those opportunities continue to exist—sometimes favorably, sometimes not.

Margaret Towle: That certainly is consistent with how we understand your career. When we look at your career, we think of Batterymarch,[2] and I think we all consider that a major achievement. What do you regard as your major achievement?

Dean LeBaron: My major achievement is surviving failures.

Margaret Towle: That's a great way to put it.

Dean LeBaron: For example, I thought at one time, probably twenty or thirty years ago, that farm assets would be a major institutional asset category. I started a farm management company and managed $100 million or something of that nature for pension funds, and the company was a failure. A failure not so much from a financial standpoint, because it made a few percent a year, but from the standpoint that it was a very localized business. It did not lend itself to institutionalization. I learned that if you sat at a table in a farm negotiation, and your adversary referred to someone else as "Bubba," get up, you're in the wrong place. The Bubba principle helped. So I was able to sell the farm management company for a tiny profit and move on. Farm assets are very popular now, but it's an extremely expensive business to manage. You can burn up 7 or 8 percent in fees every year, and the returns, attractive though they may be, don't support that sort of thing.

The other thing I tried very hard to do throughout my career was to sell investment managers on the idea of ethics as a good practice to follow. Ethics could be a disdain for soft dollars, which is heresy, of course. I never took soft dollars from clients to pay for services that were provided. I voted against directors of our own clients when they voted for shark repellents[3] and the like and proceeded to get fired in 20 to 25 percent of the cases. Matters that I considered to be ethical issues for investment managers, I don't think I was very successful at selling. It cost money. The dean of a business school recently asked me, "How much money did you make pursuing ethical strategies?" and I said, "It cost me about $50 million." I then went back and calculated the number, and I was underestimating. It was more than that.

A last failure was in tying investment thinking to a whole variety of other topics. Again, I'm a fan of bringing the hard sciences and the so-called soft sciences together. However, that didn't move as fast as I thought it should, and it's still going on—evolutionary finance, behavioral finance, whatever you want to call it. I think there's a big future there, and we may see that as it comes along. Let me just insert one other idea because it will relate to a number of things I say. I'm a secret fan of Kondratieff waves,[4] and I think we have been in a ten-year transition period, from one fifty-year period of investment management style to something else, and I don't know yet what the something else is. We probably won't know for another ten years as we go through this Kondratieff long-wave winter.[5] Our biggest exercise is, "What is that period in the future going to look like?" I have some guesses, but I don't have any very firm convictions.

Geoff Gerber: High-frequency trading[6] and many of the statistical arbitrage strategies were developed from the perspective of engineering or practical science—what you have termed "hard science." Will the next set of academics entering the real world of investing come more from the social-media side, rather than the engineering side?

Dean LeBaron: Yes, I believe so. That's my guess, and it's only a guess. I think high-frequency trading has more to do with scalping[7] than with engineering, frankly. With dark pools[8] and high-frequency trading, it looks like what we used to call it back in the old days—front-running[9] more than anything else. I don't mean to be so cynical, but it's flashing lights, and it's one set of investors having a privilege of information over others. There are a couple of ways of dealing with that. The old-fashioned way would have been for a firm to sell its expertise or rent its expertise in high-frequency trading to a group of investors and do that as a point of greater return. In the present world, we don't do that. That would be perceived as being very stupid. The intelligent thing is to do it for your own account as a trading account and trade against your own clients in that way. I'm an old-fashioned guy. I would still do it according to the former technique rather than the latter.

Ed Baker: Would you say then that the old ways of investing—the traditional styles of value investing and growth investing, if you will—are dead? Do you think those approaches now are just nonsensical?

Dean LeBaron: Oh, I hope not, but you're quite right. You've pinned me to the wall. I think I'm skeptical about anything that has worked so well for fifty years that it becomes almost our hallmark. Then you go through a period of change, which is what we seem to be in at the moment. I mean, who would have guessed—maybe you would have, but I wouldn't—that governments would price the riskiest of assets at, in effect, zero return and completely throw what we thought of as the purpose of markets—being defined as the relationship between risk and return across the risk spectrum—throw that completely in a top hat and go on and have "administrative" markets. We can't seem to get out of it—and may not be able to get out of it. So, yes, I think you're quite right. You have to be suspicious of anything that becomes almost part of our daily lexicon and is used so much, and I'm suspicious of something like value investing, although certainly that's the kind of ratio analysis that Batterymarch did. It was essentially value investing in terms of simple things like book value, yield, and all the usual stuff. Yes, I'm a cynic about a future for that.

Geoff Gerber: The Internet obviously has changed how investment work is performed and how it's conducted. As you've pointed out, it even makes location irrelevant, and it's enabled investors to become much more global without having to travel. Following up on Ed's question about value investing, will the old models of analysts who actually visit companies and talk to management in person go away completely?

Dean LeBaron: It definitely won't, because some analysts will be good at reading body language—which you can't get on the computer—and making confirmed judgments about that. But, yes, the Internet has made the investment world flat. I thought it would make the investment world efficient. Jack Bogle[10] and I used to run around saying that there are going to be substantially fewer investment people in the world because of the use of machines. We've been wrong, and people have been very kind in not remembering our earlier forecast. I continue to make the same forecast, but that's because machines have been used more as a leveling device—that is, bringing more people into the market using machines—and because machines are being used as a sales tool rather than as they were first used, in effect, to replace the kind of analytical drudge work that people previously did with green eyeshades and John Magee paper.[11]

Meir Statman: That brings us to a real puzzle as to the investment management industry. That is—knowing that the average alpha is, of course, zero and that costs are involved—how is it that we have such a large industry? What service does it provide?

Dean LeBaron: It's very hard for any of us to phrase that question, because the answers are not very comforting. Several things happened in our industry that I think are particularly important. One is that the people who are receiving a service usually are not the ones who are paying for it, or at least paying directly. There are some exceptions in terms of individual investors and the like. However, since we're servicing institutional investors, the person who's receiving the service often is the ultimate beneficiary of an institutional account, and there may be several layers of agents in between. Your consultants are certainly among those. One of the jobs of a consultant—and I think most of them would agree, at least privately—is to provide employment insurance to people on trust committees and the like, because the trustees can then say, "I wasn't the one making that decision—it was XYZ consultant who did," and it's laying off blame and adding support to all consultants. That doesn't apply just to investment management. It's well understood that the function of any consultant is to give job security cover to the people who hire them.

The other thing that happens when you separate the receipt of the service from the payment is that costs tend to skyrocket. That happens in medical services, where the costs are paid for by insurance or by the government and the person receiving the service is the patient. Even the CFA [Chartered Financial Analysts] organization, of which many of us are part and enthusiasts, now has 130,000 members paying $500 a year in membership fees. But very few of those 130,000 actually pay the $500 themselves. Their firms pay it. None of us would have originally forecast that the organization would have achieved that particular size, or there certainly would have been pressure brought to reduce the fee rather than experiencing the pressure if they can't find enough services to spend the money. I don't think I'm telling any secrets.

Meir Statman: Can you expand upon that idea? You mentioned medicine. To me, that is an interesting analogy. There currently is great pressure in medicine to reduce costs, become more efficient, and practice evidence-based medicine. When will we have evidence-based investing?

Dean LeBaron: Well, I thought we would have had that when we had the first performance measurement committee, and that's now about twenty-five years ago. Four or five of us met and proposed that all firms produce, according to certain rules, regulated performance measurement comparisons. Now I will tell you a secret. Having done so, we knew that we would make those numbers more convincing, more useful, or more used anyway, for comparative analysis of one investment manager versus another. The analogy we used, "cleaning up the factory floor," made people think that cigarettes were actually less harmful if they were produced in a cleaner environment. However, should we—and we considered this—in fact go to the investment managers and give them some suggestions on how useful, or not useful, historical performance measurement figures would actually be in terms of forecasting future performance? We declined to do that for the obvious reason: Who wants to hear that it takes seventy-five years to achieve a 90-percent confidence level, or whatever it was at the time? It's probably less now, because there's not as much deviation. In any event, we thought of that. It was used for performance measurement or for marketing purposes. Our clients would ask us the question: "Why is it that the investment management marketers who come to see me all have much better numbers than the averages, and yet more than half of my managers have numbers that are less than the averages all the time? What is the reason?" We all know that happens if you incubate funds, then only produce and market the funds that have done better than the average. There's a self-fulfilling prophecy in this, i.e., those are the only ones that sell.

Ed Baker: Government and central bank policy and actions have dominated the markets in the past few years. One could almost think that we've shifted into a more top-down world than we used to have, when managers were so bottom-up in their approach. Do you think that's going to continue? Does that mark some kind of a seismic shift in the way the markets work?

Dean LeBaron: I don't know. I'm not sure that I think that the markets have been so dominated by regulation and the like. There's been the appearance of that. I chaired an SEC [Securities and Exchange Commission] committee on corporate governance some thirty years ago, and I proposed at that time that you wanted to have as much trading as possible, including insider trading. That was because you wanted to have good price discovery, and you couldn't get good price discovery as long as you had some of the best-informed market participants being excluded from the market. That was like saying you could be a clunk and not well-informed, and that would still produce a good price. That was stupid in my opinion, but the idea that you would encourage insiders to trade by some means was offensive to many people. I'm a great fan of libertarianism,[12] but with disclosure, and I think sometimes we lock up the disclosure. For example, as we all know, there's a fair amount of lobbying going on in the United States. It's a big industry, and it's highly profitable. Some people would call that bribery, but it's a subtler form of bribery, and basically you don't see very much information about it. Take, for example, the story on national security leaks. That involved an employee of a private contractor, a defense-oriented firm with many government connections. That's an insider situation, and nobody asked the question about how much the NSA [National Security Agency] spends and whether it was included under the sequester program—which, of course, it was not. What I'm saying is that there's not as much disclosure as there should be in a fully regulated market. It's an administrative market, I agree, but much of the administration is just sort of an aside, just lip service. We're all familiar with the huge prospectuses that are written in the United States. Most of us tend not to read them and don't rely on them for investment information.

Margaret Towle: It seems like what you're really talking about is accountability on the part of the advisor and the investment manager. To go back to an earlier comment that you made regarding trust committees relying on advisors, it's like the principal-agent problem.[13] What do you think about recent trends in the industry toward fully discretionary accounts—what you might call the outsourced chief investment officer—where the advisor is a consultant who's actually assuming accountability as a co-fiduciary with institutional clients? It's great to have full disclosure, but if you don't have accountability, it's really not going to do much.

Dean LeBaron: As nearly as I can tell, most of the people who have accountability also have directors' and officers' insurance to make sure that if they get stuck, they're not the ones who pay for it. If you have accountability where it's actually got some teeth in it, I think that's fine. I'm just not aware that it's taking place.

Mike Dieschbourg: The issue of whether the market is a puzzle, or a mystery, really comes up in your complexity series and your thoughts along those lines. With the increased complexity and volatility surrounding our global markets and, as we've talked about, the changes going forward, do you see a wave of innovation to navigate through the financial markets' booms, busts, and bubbles by using a multi-lens framework? We've talked about the death of value and growth investing and the bottom-up approach. Do we need to be moving to our multi-lens framework that includes micro and macroeconomics, finance, physics, behavioral finance, the political aspect that we've talked about, even biological disciplines, to navigate these markets? Is that where you see the market going? Is it really more of a dynamic in action?

Dean LeBaron: When I look at the divisions in some market portfolios, I'm amazed as to who's doing what. I mean, there are tiny little increments of great specialists and specialties. I like to stand a bit back from that, as I mentioned earlier in somewhat parenthetical expressions. I'd prefer, if I can, to find the questions that nobody's asking. I recently thought of an old letter that was written by our friend, the late Fischer Black,[14] who reputedly—and I think it's true—suggested that he would start an investment service. People would pay $5,000 a year for his service, and he was offering his first newsletter for free. His first issue said something along the lines of: "Since the markets are efficient, whatever portfolio you're holding is the right portfolio. Do not incur any transaction costs to make any changes whatsoever. Hold this portfolio forever. Please send $5,000 for a continued subscription if you would like me to repeat this advice to you every month." Needless to say, Fischer didn't get very many subscribers.

However, I think his advice is probably true in the sense that today, it's not so important what you own, but it's all in how you own it. Almost everyone who has a security of any form has it in the name of a custodian or trustee or in some name other than his or her own. Those of us who know or remember people who were around during the Depression know that people then didn't trust banks or the like; they didn't trust other people. They put their assets in their own mattresses or in gold bars in a Midas room, or whatever the case was. In any event, they held them in their own names. So it strikes me that one of the investment imperatives that we may run into as we come out of a Kondratieff wave is: "Who owns the assets? Do you own the assets, or is it an intermediary, such as a large financial services company (and what you really own is an unsecured obligation payable by that broker or bank)? Do you really want that type of company to be the holder of your assets, adding that to your other risks of investing?" Probably not. So I don't know. I've used that as an example of an investment strategy that, to me, is more meaningful than owning small-cap Asian stocks ex-Japan, or whatever the case may be. I mean, there are all these little small increments of specialty. On the other hand, I do agree with the implication of the question in the work being done on behavioral finance, bringing psychology into investment management. It's just going much slower than I expected.

I will admit to one other of my many mistakes, and that is that I've always been interested in prediction markets.[15] The idea is that people can bet on an outcome, and they reveal their biases by placing their bets on certain outcomes. Most individuals have a higher degree of conviction about their anticipated outcomes than is warranted, except there's probably an insider somewhere who has the judgment or knowledge and who will reveal their convictions with money and make money out of prediction markets. That was fine, except the leading prediction market company turned out to have problems, and that didn't help. It's still alive, but it's sputtering. The idea is a good one.

Mike Dieschbourg: So the follow-up for that would be, if you like complex theories—and you talked about that, the information that is in prediction markets—it seems that to be successful going forward, the next generation of wealth management from an advisor, consultant, or the investment management side needs to be almost a master of complexity in order to look at all of the different disciplines and be successful in navigating through. Is that what you're saying?

Dean LeBaron: Right, a master of complexity—and ideally more holistic than a separate specialist. Now the world shouldn't have too many holistic managers. You can't have too many. However, if that approach happens to fit your psyche—and this goes back to my observation at the beginning of finding an investment strategy that fits you—you're more likely to succeed. If a market phase is not one that suits your own particular psyche, you're just out of luck. Don't try to adjust to it; go do something else.

Margaret Towle: It seems like that's good advice for anyone, not just advisors.

Dean LeBaron: Yes, I think that's probably true.

Ludwig Chincarini: I have a question related to what advisors and others are asking about the current marketplace. I was just at a conference, and we talked about the Federal Reserve. I get calls from people all the time asking, "What's going to happen? Will this huge balance sheet of the Fed turn into inflation, or will it turn into something else? I'll throw in one other thing. One individual said that one of the arguments is, "Well, the Fed will let the contracts on its purchases mature, and therefore it won't have any pressure." But someone still will have to buy the Treasuries that the Fed has been purchasing. So my question to you is: What do you think is going to happen with this huge balance that the Fed has, and what other implications might it have for housing and things of that sort?

Dean LeBaron: The implications are pretty horrendous, aren't they, if you think about it. In a way we're asking: "How do you get out of major imbalances without damage?" There's very little record historically that it's possible, and the imbalances are usually cultural and political as well as economic. (I promised myself that I would not be a grouchy old fuddy-duddy, but I am, somewhat.) I think it comes down to promises. We have developed a system in the United States where we believe in promises. We believe in promises that with the ability to pay, it will be paid; and with the ability to provide value, value will be provided; and so forth. That's probably not going to be the case. Somewhere along the line, some promises are going to be broken, and it may start with the Fed, which took on a burden that, in my opinion, is wrong. For example, as long as the Fed is buying $85 billion in bonds a month, it papers over the deficit. The deficit in the United States is almost fraudulent because it's not based upon—or shouldn't be based upon—2-percent money. It should be based upon 5- or 6-percent money, as it is in many other things. I don't see how you can avoid an eventual painful exit, but I'm not sure whether that will be this year or another. I don't know whether any of you ever had a serious automobile accident. I have, and unfortunately, I'm not bragging. When you're in the midst of it, it seems like it's happening in very slow motion, and then in hindsight, it's not. It's actually happening very fast. It's a snap roll,[16] as the case may be. I feel very much the same way in looking at the Fed and its activities intervening in financial markets. We can't get out of it, and it feels like it's a slow roll.

Ludwig Chincarini: One of the complications right now for many people is what to do with their money. Gold seems to be going down. Inflation, not yet. Treasuries seem to be going up—I mean, yields are going up and Treasury prices are going down. China may be overvalued. What does one do at this point?

Dean LeBaron: You're right that there's no place to hide. In the first place, you have to start out by saying, "My investment goal is to lose as little money as possible, not to make money." That's a tough resolution to make, and this does not win you clients. Secondly, you more or less have to ignore some of the current market. The advantage of gold is not so much that the Chinese and the Indians and so forth like it, but that you can own it conveniently in your own name. Banks have underground bins with your name on them that hold your gold. It's rather funny. I'm not sure what it means when Germany asks for its gold back from the United States, and the United States tells Germany that it will take seven years to deliver.[17] Somehow, the gold market is weird. I don't understand it. I think that some strange things are going on there, which would seem odd even to an experienced gold trader. The difference between physical gold prices and GLD—paper gold—also just makes me suspicious. In any event, I am not a gold bug, but I'm attracted to gold because it is an asset that you can hold conveniently in your own name. Similarly, unencumbered land would offer the same advantage.

A year or so ago, a company that prints currency came to my attention. It had no debt, and I thought, "My goodness, that, in my mind, is the ideal company investment." It seemed attractive, and it had never occurred to me as an asset niche. Needless to say, it doesn't account for much money as a category. But you're quite right. There are very few obvious places to hide. I am a fan of China, only because I think China is conceivably the country that is proving to the United States that we're not number one. I've been a fan of China ever since I was there twenty-five years ago, and it's the only country in which I own stock. Its government has the discipline. When they say they're going to shut down the economy in order to dampen inflation, they will shut down the economy. I don't believe the United States would do it, or could do it.

Meir Statman: Can I take you from this discussion and link it back to the newsletter by Fischer Black that you mentioned? What Black seemed to say to advisors, if I interpret this accurately, was: "Don't worry your heads about what the Fed is doing and where gold is going. Markets are going to do the work for you, and your role really is to educate your clients and hold their hands." Why is it that advisors are so much into playing *investment* manager, rather than playing *investor* manager?

Dean LeBaron: You're absolutely right—that is exactly what he said, and I have been guilty of ignoring that, I must admit. I can remember one quarter, or one of several quarters in which the investment results of Batterymarch were poor, and I said: "I've got to go to the committee meeting to talk about these terrible results, and I don't have a good explanation. So let's do something else." So we did a psychology test on the propensity of committee members for risk-taking with questions such as: "Would you like to jump out of airplanes, or would you prefer to play chess? Do you like red or brown?" and so forth. We did different little tests on computers, small computers that the committee members could then keep. The demonstration showed that the funds run by the committee members were far more likely to be attuned to their psychological profiles than to the actuarial assumptions provided by the consultants. My motive for doing this test was impure—it was a distraction—because I didn't know what to say about the investment results. It was an interesting item, and I got a financial award of some sort for the research. I think it was important research. However, my motive for doing it was that I really didn't want to say anything about the market. So I'm guilty of using distractions.

Ed Baker: But suppose your investment objectives are just as simple as, "I don't want to lose money, but yet I need income." Then what paths of investment can you really pick? You still have to be able to make some sort of investment decisions over time in order to achieve those objectives for the client.

Dean LeBaron: Yes, that's right. The market in its great skill produces real estate investment trusts and other investments that are essentially vehicles to convert what normally would be considered income into requiring you to pay it out so that it looks like a dividend. There are vehicles that create that for you, but it still is an equity vehicle. I'm a fan of total recurring calculation rather than the legal definition. Other people are skillful at pulling out the legal definitions and taking advantage of them. I'm not.

Ed Baker: And should one hold government bonds now? For example, if you're an investment advisor and your client has a large allocation to U.S. Treasury bonds, what advice are you going to give them at this point? Are you going to sit there and let them passively watch interest rates rise?

Dean LeBaron: I don't know. I am an investor, and the U.S. currency that I own, which is not much, is in the form of TIPS [Treasury inflation-protected securities]. So presumably, some of that's taken care of. Obviously, TIPS are doing well. Normally I would not own that, in the sense that the U.S. government market has been administered, and it hasn't been a free market for more than two years. I will admit also that I own some Brazilian real. In the case of the United States, we're benefiting from being, as somebody said, "the best-looking horse in the glue factory."[18]

Margaret Towle: Just to shift gears slightly away from current strategy and outlook, let's go back to an earlier point you made about ethics and talk about what you said prior to the 2008 financial meltdown. Back then you really implicated financial analysts and independent directors, and you touched on that somewhat again today. I was wondering, now that we've been through a number of fiscal mismanagement and corporate scandals, do you still believe these two groups are the primary drivers in this conduct, or are there other influences? You've mentioned the Fed a couple times.

Dean LeBaron: I now think that financial analysts and independent directors are off the hook. It comes back to shareholders, and the first part, of course, is that institutional shareholders aren't real shareholders. I mean, they don't exercise their governance role at all, so they're not really very good shareholders. Individual shareholders are not sufficiently well-informed, so the corporations really function as unrestrained sources of power, and they're getting away with it. It's obvious when chief executives on the team are paid multiples—I forgot what the current multiple is, 100 to 200 times the average salary of an employee in that corporation[19]—that something is terribly, terribly amiss. I live in Switzerland a fair amount of time, and the Swiss blame all of this on the United States. They call it the American disease—corporations operating without any accountability. The Swiss banks, of course, also are completely guilty of the same thing. They're throwing stones at Americans when they shouldn't. But certainly Americans were the leaders in unbridled executive salaries, in unrestrained salaries for corporate leaders, which is probably the best illustration of this.

Geoff Gerber: Looking ahead, you've always argued that being first is often best, sometimes even better than being lucky, but being first is best. Obviously, you were one of the early institutional investors in emerging markets. I know you've mentioned China already. Sitting here today, in what area would we look for the next first?

Dean LeBaron: You're absolutely right. First is best, and it's more fun. If you're wrong, people don't remember it because nobody else picked it up. If you're right, people will remember it and give you great applause and satisfaction. So I'm still of that same vein, and I've offered my best choice for that: It's not what assets you own, but how you own them that may be the best consideration today. In terms of location, I'm not sure it makes any difference. I'm a subscriber to the view that you should go where the Chinese are going. The Chinese have got the money. At the moment, the Chinese are investing large amounts of money in Middle Africa (Nigeria, Ghana, Kenya, and so forth), and that's probably not a bad thing to do. You can't invest much money that way. As an individual, you can, but as a large institution, you can't. Also, the Chinese are not investing in the United States, but they are investing in Canada and Mexico. That's probably very good. So, looking at North America as a whole, I would have Canadian and Mexican portfolios, and I probably wouldn't have very much in the United States. I think that's probably it. In addition, as I said, unencumbered land—a couple of large land-holding companies look really interesting. However, in general, this is probably not a time to be terribly cute with investments; it's a good time to be fairly sleepy. Maybe it's an excuse.

Ed Baker: Do you think there's a role for hedge-fund-type investing? It seems like most of what you've alluded to has been long-only. But what about strategies that try to go on both sides of markets?

Dean LeBaron: I always think that's terrific. I like it, and I've done it. It's hard to do psychologically—it doesn't make any sense. On the short side, there's unlimited loss, of course. Not so on the long side. However, most of the hedge funds I know don't run long/short portfolios. It's just a cover for how they treat the income. But, yes, if you've got the propensity and you can stand the heat of being short in a rising market, good, go to it. I must admit I've done it a few times, and I find it's not very good for my stomach.

Ed Baker: But if you can trade multiple asset classes, obviously, you can effectively introduce hedging strategies.

Dean LeBaron: Yes, you can, and it's a good idea if you've got the stomach for it. Most people don't, which is why it's not done except on a trading basis. However, on an investment basis—I'm trying to think of an investment example. I know a few people who have done and are continuously doing what you call investment shorts, by which I mean an indefinite time horizon on which they plan to be short on some asset. It's rare, but yes, it's probably a fairly good return. The fact that it's done mostly inside firms suggests that it's the kind of strategy that would produce a return of a couple hundred percent a year.

Mike Dieschbourg: With all of your background in the different hard and soft sciences, what tools do you think we need today to capture the complexities of the marketplace? You did a great job on the client side. What tools do you think we need to build today to be successful going forward in the future as investors?

Dean LeBaron: I would encourage people who are in investments to spend some time in another field for ten or fifteen years and then come back to investments, and vice versa. I've been amazed at the intensive specialization that we've gone through, and there tends to be more demand for specialization as we report in lines to other people. I'm holistic in approach, and I don't quite know how to put that into place. However, I remember looking for people who didn't have the traditional Harvard business school track, although that was the track that I had done. I look for people who are musicians or philosophers or otherwise. I think more of that would be better.

Meir Statman: Can you say something about the current state of academic finance as you see it? You've been part of it, and surely you have been working alongside it. When you look at what has happened in the past decade in this area, what do you see, and where do you think we should go?

Dean LeBaron: I'm not close enough to really comment on that very well. I'm asked to speak in an academic setting every once in a while, and I do. I'm always so impressed with the bright people around—and the bright questions—particularly the individuals who are continuing to be attracted to the United States from other countries. I keep saying that I think it's going to reverse and that there will be a flow from this country.

Meir Statman: I'm actually not asking about academia generally or American universities, but rather the state of our knowledge of finance and the role of academics in finance in generating that knowledge.

Dean LeBaron: It should be better. We should know more about finance and the markets than we really do. I'm amazed, and I have always been amazed, at how little we know. However, there's good research going on. Back in 1980, as a way of showing my appreciation to the academic world that helped shape Batterymarch's approach to investment management, we established a fellowship program to promote academic research in the fields of finance and investment.[20] In fact, Meir Statman was a Batterymarch Fellow way back when. He did good work, and I'm a fan of promoting it. I think our research into finance is coming along fine, but I can't say how I would change it.

Endnotes

1 Richard (Dick) F. Vancil (1931–1996), whose teaching career at the Harvard Business School spanned thirty-eight years, was a nationally recognized expert on accounting and considered an authority in the area of chief executive succession.

2 Headquartered in Boston, Batterymarch Financial Management, Inc., was founded by Dean LeBaron in 1969. Since 1995, Batterymarch has been a wholly owned, independently managed subsidiary of Legg Mason, Inc., one of the world's largest investment management companies.

3 Shark repellents are any measures undertaken by a corporation to discourage unwanted or hostile takeover attempts.

4 Kondratieff waves—also called supercycles, great surges, long waves, K-waves, or the long economic cycle—are described as regular, sinusoidal-like cycles in modern capitalist economies. Averaging approximately fifty years in length, the cycles consist of alternating periods of high sectoral growth and relatively slow growth. The cycles are caused by the periodic renewal of basic capital goods and revealed in price levels and trade statistics, and appear to set in motion (or be set in motion by) technological innovations and social upheavals. The Soviet economist Nikolai Kondratieff (also Kondratiev) (1892–1938) was the first to suggest that industrial economies followed a cycle of change in prices and production. His theories were out of favor with the Soviet government because they did not support the idea that capitalist nations were in danger of imminent collapse. Kondratieff was sent to a Siberian concentration camp, where he was executed in 1938. Recently, the financial crisis of 2008 increased interest in theories of long economic cycles as one potential explanation of its cause.

5 A "Kondratieff long-wave winter" is a reference to the four-season Kondratieff model favored by investment theorist Ian Gordon, in which spring represents moderate growth from a stock market and inflationary bottom, summer is characterized by accelerating growth and high inflation, autumn is typified by declining inflation and asset bubbles, and winter involves the collapse of asset bubbles.

6 High-frequency trading (HFT) is the use of sophisticated technological tools and computer algorithms to rapidly trade securities. HFT uses proprietary trading strategies carried out by computers to move in and out of positions in fractions of a second. Firms focused on HFT rely on advanced computer systems, the processing speed of their trades, and their access to the market. Many high-frequency traders provide liquidity and price discovery to the markets through market-making and arbitrage trading, and high-frequency traders also take liquidity to manage risk or lock in profits.

7 Scalping, also often known as "front running," is the practice of purchasing a security for one's own account shortly before recommending that security for long-term investment and then selling the security at a profit upon the rise in the market price following the recommendation. The U.S. Supreme Court has ruled that scalping by an investment advisor is a fraud upon clients or prospects and is a violation of the Investment Advisers Act of 1940.

8 Dark pools are trading platforms that allow traders to buy or sell large blocks of shares without the prices being revealed publicly until after trades are completed. Dark pools have been criticized for their lack of transparency and the potential for less-efficient pricing in traditional open stock exchanges.

9 Front running, see endnote 7 (scalping).

10 Jack Bogle (1929–) is the founder and former chief executive officer of The Vanguard Group. In 1975, Bogle established the Vanguard 500 Index Fund, the first index mutual fund available to individual investors. Bogle is well known for his position that index funds are superior to traditional actively managed mutual funds.

11 "John Magee paper" is so called in reference to John Magee (1901–1987), a stock market analyst and leading authority on technical analysis and classical charting. In 1948, Magee and Robert D. Edwards published *Technical Analysis of Stock Trends*, widely considered to be one of the seminal works on trend analysis and chart patterns.

12 In general, libertarianism is a set of related political philosophies that uphold liberty as the highest political end. This includes an emphasis on individual liberty, political freedom, and freedom of association. Libertarianism also is a term often used in the United States to denote market liberalism, or a political ideology that combines the belief in a free market economy with personal liberty and human rights.

13 In political science and economics, the principal-agent problem, or agency dilemma, concerns the difficulties in motivating one party (the agent) to act in the best interests of another (the principal) rather than in the agent's own interests. A common example of this relationship is corporate management (agent) and shareholders (principal).

14 Fischer Black (1938–1995) was an American economist associated with the University of Chicago, MIT Sloan School of Management, and Goldman Sachs. In 1973, Black and Myron Scholes (1941–) published their option-pricing formula, which became known as the Black-Scholes model. This model, which represented a major contribution to the efficiency of the options and stock markets, remains a widely used financial tool.

15 Prediction markets (also known as predictive markets, information markets, decision markets, idea futures, event derivatives, or virtual markets) are speculative markets created for the purpose of making predictions. Current market prices can then be interpreted as predictions of the probability of the event or the expected value of the parameter. For example, a prediction market security might reward a dollar if a particular candidate is elected, and an individual who thinks that the candidate had a 70-percent chance of being elected should be willing to pay up to seventy cents for such a security.

16 A snap roll is an aerial maneuver in which an aircraft is put through a fast, sharp roll of 360° about its longitudinal axis without changing direction or losing altitude.

17 In January 2013, the Bundesbank, Germany's central bank, announced it would move 647 tons of gold—or 54,000 gold bars worth about $36 billion—to Frankfurt from central-bank vaults in the United States and France. This would bring the Bundesbank's holdings in its Frankfurt

storehouse to 50 percent of its total gold assets, up from the current 31 percent. The Bundesbank, the second-largest gold holder in the world, said that part of its goal in the move was "to build trust and confidence domestically." According to the plan, Germany's gold repatriation will be completed by 2020. Questions have been raised as to why the transfer will take seven years to complete.

18 "Best-looking horse in the glue factory" has been attributed to Erskine Bowles, the former co-chair of the National Commission on Fiscal Responsibility and Reform (2010). The phrase also was used by Richard Fisher, president of the Federal Reserve Bank of Dallas, in an interview with CNBC's Maria Bartiromo (2012). http://www.aspenideas.org/session/can-federal-reserve-stimulate-economy-0.

19 According to a Bloomberg report in April 2013, the average multiple of chief executive officer (CEO) compensation relative to the pay of rank-and-file workers across the companies in the Standard & Poor's 500 Index is 204, up 20 percent since 2009. This multiple was based on CEO pay for fiscal years ending in 2011 or 2012, as disclosed in the companies' most-recent filings, and U.S. government data on worker compensation by industry. Calculations by academics and trade union groups have estimated that the multiple grew from 20:1 in the 1950s to 42:1 in 1980 and 120:1 by 2000 and 170:1 in 2009. http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html.

20 In 1980, Dean LeBaron established the Batterymarch Fellowship Program to "promote academic research in the fields of finance and investment by encouraging forefront research by creative, enthusiastic academicians." Meir Statman was named a Batterymarch Fellow in 1985.

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