

SKBA CAPITAL MANAGEMENT

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Three Fallacies of Modern Finance:

The Drama of Life in a Sand Castle

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"And so castles made of sand,
melt into the sea, eventually."
-Jimi Hendrix

The sand castles of modern finance have contributed to the recent conjuring and destruction of billions of dollars in wealth. As margin debt rises to record levels and the Nasdaq re-ascends, we think it is useful to reflect on a few accepted financial principles that lack legitimacy.

Three accepted wisdoms contribute to the illogic of modern finance. We will briefly address why each is, at best, an oversimplification. This troika of illusions is:

- (1) Market efficiency,
- (2) Risk as beta and tracking error and
- (3) The Fundamental Law of Active Management, which treats depth and breadth as discrete phenomena.

This set of false wisdom prevents an understanding of the

- (1) Role of prices,
- (2) Relationship of risk to goals, and
- (3) Limitations of participants in the markets.

1. Market Efficiency

If no one is trading on incremental information then how do prices incorporate that information? A simple understanding of microeconomics and price theory should inoculate anyone from believing in market efficiency. If markets are efficient, then it should push back on price theory and cause us to completely re-work price theory.

The assumption of microeconomics and price theory is that prices incorporate information because supply and demand shift in reaction to changes in price, *whereas* the assumption of efficient markets is that one should do the same regardless of the prices, because the prices reflect all the information. **Active market participants make the markets appear efficient.**

2. Risk

The accepted view of risk is that one can measure it by volatility and tracking error. In other words, risk is rapid shifts and doing differently than the other guy. This is a nice social definition that favors stability and similarity, but does not describe anything about finance or underlying asset values.

In financial terms, **risk is not achieving your financial goals**. Risk is returns that fall below the actuarial target for a sustained period -- the risk is that you can't meet your financial commitments. The risk is not that you aren't as wealthy as the guy next door. In the last decade, we have mistaken social risk for financial risk, and the financial markets are now adjusting. Unfortunately, the social bias has been inserted into the financial metrics and even our legal structure -- funny how that happens.

3. The Fundamental Law of Active Management

$$IR = IC * \sqrt{N}$$

IR = Information Ratio,

IC = Information Coefficient,

N = Breadth.

The theory is that one generates excess returns or an information ratio through the

- (a) Information Coefficient -- making good decisions and
- (b) Breadth, or the set of opportunities to apply the decision-making framework.

In Active Portfolio Management, Grinold and Kahn propound this idea.

This sounds good, but has a logical weakness similar to market efficiency: causality has been forgotten. *Finance has mistaken descriptive systems for prescriptive systems.*

The Information Coefficient, IC, and Breadth, N, are functions of the same underlying thing – depth of knowledge. IC is an expression of the value of what you know, and N is simply the number of opportunities you have to apply what you know.

It is interesting to imagine being able to separate things into an information coefficient and breadth, but does it make any sense to think about skill as distinct from opportunity? What does skill absent opportunity or opportunity absent skill look like? ***The key is to only invest when you have a depth of knowledge. What could be more fundamental to active management than that?***

In an article on Leon Black of Apollo Management in the early 1990s, Mr. Black stated that he had learned the most important lessons about business not from Harvard Business School, but Shakespeare. The financial world and financial wisdom abstracts away from the fundamental human drama that drives the economy. This abstraction is not effective when it loses touch with the human Shakespearean drama which drives the economy -- and also loses track of the

- (2) Role of the market in setting prices,
- (3) Financial goals of the client and
- (4) Limits of the financial players.

At SKBA, our perhaps-old-fashioned approach for *profiting from the drama without getting too caught up in it*, is to look for companies with high probability business opportunities that are not discounted in the price of their stock. We generally do this by:

- a. Looking out three to five years into the future, which is approximately eleven to nineteen quarters further out than many market participants, and
- b. Avoiding businesses where we don't have a good understanding of where they will be in three to five years.

This gives us a list of companies, which we may use in building a client portfolio. The client portfolio is then built to meet the client's goals with the greatest probability.

We find that using solid companies as building blocks, we can construct a portfolio can withstand, and even benefit from, the rising and falling of the financial tides.

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