PACIFIC CURRENT GROUP

COMMENTARY

The Seductive Allure of Deep Research

By Paul Greenwood, CFA

Investment managers often tout their team's deep research abilities, claiming to devote hours and hours to each investment they consider. However, managers and their evaluators alike tend to overlook the tradeoffs involved with doing more research. Here we explore three challenges related to investment managers' research efforts and offer some tools for investigating whether an investment team has thoughtfully calibrated their research to their strategy's process and philosophy.

Introduction

For most of us in the manager evaluation business, there's a certain assurance that comes when terms like "robust," "rigorous," "extensive," or "in-depth" are used to describe an investment manager's fundamental research efforts. The thinking goes, investment strategies require some amount of fundamental research to implement successfully, and thus more research should make a strategy more successful. While that logic is seductive, reality may not be so straightforward.

To be clear, I am not suggesting that less research is the best way for a manager to triumph in the hyper-competitive world of investment management. Many great investment firms owe their investment success to the depth and rigor of their research efforts. However, evaluators who subscribe to the "more is unambiguously better" view tend to overlook the additional challenges that accompany deeper research. They also risk missing out on a broad variety of strategies that may be every bit as robust as their more research-intensive counterparts.

In this commentary, I focus on three key challenges related to the relationship between investment research and investment success. The first challenge is recognizing our innate preference for knowledge-intensive strategies. The second is understanding the tradeoff between research depth and research breadth. Lastly, I discuss the behavioral traps and biases that frequently accompany deeper research efforts.

In each section, I've also suggested questions that portfolio managers might ask themselves to better calibrate their processes—or that an evaluator might ask a manager to make sure he or she has thought through these challenges carefully.

Challenge One: Managing Our Need for Comfort

Let's begin by acknowledging the obvious: everyone takes comfort in deep, rigorous research. Manager evaluators love it, and within investment firms, much credit is given to those who dig the deepest. Undoubtedly, this stems from a sense that there must be a close relationship between knowledge and valued-added insight.

This general observation may be true in some other occupational fields, but in investment management, the ultimate question isn't how much you know, but rather, does your approach to forecasting future returns work better than the approaches employed by others?

In this vein, it appears far easier for most evaluators to take comfort in a manager's specific knowledge on individual names in his or her portfolio than in the compelling economic intuition, thoughtful design, and/or consistent application of a robust investment process. This bias remains even though these latter process-based attributes are often far more relevant to the success of a strategy than company-level knowledge.

For example, when an investment manager underperforms, it is common for the manager and manager evaluators alike to find solace in the depth of that firm's fundamental research. This defense likely arises in response to the natural fear that accompanies underperformance. The manager's knowledge of companies makes everyone feel more "in control" during such difficult periods. Of course, while such knowledge may enhance investor patience, it doesn't mean the manager can control the future any better than his peers with less depth-centric strategies.

Similarly, many investment managers often suggest that their portfolio will hold up better than the market during a correction. The stated reason for this confidence is their knowledge of their holdings. I will assume these managers recognize there is no causal relationship between their knowledge of a company and how well it performs. However, in such statements you see hints of a logical fallacy: that the better they know a stock, the less potential it has to decline. It is as if the only stocks that go down in price are ones owned by the ignorant masses. If this were the case, the statistics on active manager performance would undoubtedly look far more compelling than they do.

Questions for the Portfolio Manager

- *What does the investment process rely on most to succeed? How labor-intensive are the essential inputs?*
- *Would additional research resources help or hurt the results? Why?*
- *Have results improved as you have added research resources?*
- *At what level of information granularity are most insights generated?*

Depth vs. Breadth Across Investment Strategies

May Benefit from More Depth	May Benefit from More Breadth
• Highly concentrated portfolios	• More diversified portfolios
• Lower portfolio turnover	• Higher portfolio turnover
• Smaller, narrower selection universes	• Larger selection universes
• Focused on longer-term factors	• Focused on shorter-term inefficiencies
• Invested in larger cap corporations with more complex business structures and revenue models	• Invested in smaller cap companies with simpler business structures and revenue models

Challenge Two: Balancing Depth and Breadth

In a world of finite time and resources, deeper research comes at a cost: reduced research breadth. As a result, the implicit question confronting all investment managers becomes, what is the expected incremental return for doing more research on a given opportunity versus deploying those resources across other opportunities?

To answer this question, one must firmly understand not only which market inefficiencies a given strategy is trying to exploit, but also the abundance of these opportunities in their selection universe and how much effort is needed to generate actionable insight. With such knowledge, a manager has the potential to optimally calibrate his team's research efforts.

To borrow from investment theory, we can turn to Richard Grinold and Ronald Kahn's well-known Fundamental Law of Active Management, shown below.[1]

$$IR \approx IC * \sqrt{Breadth}$$

According to this framework, the information ratio, or the expected annual excess return per unit of active risk, is equal to the information coefficient (what we think of here as forecasting accuracy or skill) multiplied by the square root of breadth (defined as the number of independent investment decisions). While breadth in this framework is defined slightly differently than the research-focused breadth I discuss in this paper, these meanings are close enough to underscore the idea that a manager with a thoughtful, breadth-oriented process can achieve similar outcomes to his depth-oriented peers. As the table above shows, strategies with certain characteristics may indeed be better equipped to sacrifice depth for breadth or vice versa.

As I discuss in a previous paper, "Manager Evaluation: Cutting Through the Noise," uncovering unique information that is not already reflected in security prices is a difficult, though not impossible, task. Though some active managers still do this incredibly well, I would argue that most highly successful managers today are much more reliant on their superior interpretation of widely known information than they are on uncovering information that others don't possess. To the extent this observation is true, there comes a point at which the pursuit of obtaining incremental information actually comes at the cost of performance.

Questions for the Portfolio Manager

» *What inefficiencies are you trying to exploit? How long does it typically take for an investment to play out?*

» *What key data points do you need to consistently exploit this inefficiency?*

» *What is the incremental benefit of each additional hour or day of research?*

» *How does the portfolio turnover compare to that of portfolios managed by other investors with comparable processes?*

1. Richard C. Grinold and Ronald N. Kahn, "Breadth, Skill, and Time," *The Journal of Portfolio Management* 38, no.1 (Fall 2011): 18-28.

Case in point, one successful manager I know is run by a team that has designed their investment process so that they must only seek answers to a handful of key questions about each idea under consideration. Promptly securing these answers is critical given the specific inefficiencies they are attempting to exploit. Without such promptness, the returns on incremental research can quickly turn negative because delay usually means purchasing at higher prices. The more limited scope of their fundamental research effort may make for less impressive and engaging discussions with manager evaluators, but such strategies can be every bit as effective as the best of the depth-focused investment firms.

From a manager evaluator's perspective, the challenge shouldn't be determining the depth of an investment manager's research. Rather, it should be how well the manager strikes the right balance between depth and breadth given the specific investment strategy being employed.

Challenge Three: Avoiding Behavioral Traps

While additional research often yields incremental insights, the more extensive the research, the more challenging it is to manage behavioral biases. For example, I once met a manager who, in an effort to extol the unparalleled depth of his firm's research, emphasized that on average they spent 250 to 1,000 staff hours on each new investment prior to investing. While seemingly virtuous, just think of how such a process increases the risk of falling prey to various behavioral traps.

How often would a manager devote hundreds of hours to a potential investment only to decide the idea wasn't quite compelling enough or that it was just slightly outside his pricing parameters? The greater the time devoted to researching a particular opportunity, the more powerful the subconscious force encouraging the investor to justify the sunk cost devoted to analyzing the opportunity.

Behavioral biases are just as prevalent when it comes to selling stocks. As the collective time committed to covering a holding grows, so does the risk of succumbing to anchoring and loss aversion biases. If the investment evolves in an adverse manner, selling means acknowledging that—despite all the time devoted to analyzing the investment—a mistake was made. Such an acknowledgement becomes more emotionally difficult and behaviorally challenging when fewer decisions are made in the process. Other biases rear their heads in situations where the investment is wildly successful and when retaining that winning position becomes a welcome reminder of their "skill" and hard-fought achievement.

The problem here is that conviction is not mutually exclusive with bias. In fact, they often build upon each other. Talented investment managers can surely put in their hours of extensive research, but when they choose to do so, they should either be self-aware enough to distinguish the true source of their conviction or have designed an investment process that limits the risk of various behavioral biases influencing their decisions.

Questions for the Portfolio Manager

- *How much research is typically done to get each name in the portfolio? What proportion of ideas are rejected at each stage of the research process?*
- *How frequently are attractive holdings displaced for more compelling opportunities?*
- *How does your patience for a holding differ based on its prior performance in the portfolio?*
- *If you were starting your business all over again from scratch, how would your portfolios look different?*

Conclusion

It's easy to become enamored by displays of research depth, but the key takeaway here is that research needs to be considered in the context of a manager's philosophy and process. There's a unique and appropriate level of research depth for each each strategy, and it's actually possible to have too much depth. Thus, the ideal research effort is one that optimizes the tradeoff between research breadth and depth while remaining highly cognizant of the noise and behavioral risks that accompany all fundamental research efforts.

About the Author

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