WHITE PAPER

Gaining an "Edge" in Investing

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A large portion of the investment world is focused on one objective, outperforming both market indices and other investors. There has been a significant shift toward passive or indexed investing in recent years, but about 55% of the dollars invested in equities remains in the hands of active investors who are trying to outperform their peers. While the desire to outperform is certainly understandable, it is also unfortunate to some extent in that it leads many investors to lose sight of the ultimate objective of their portfolio and induces them to focus on short term results often leading to excessive and counterproductive activity.

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This statement is certainly self-serving, but a financial advisor can have a significant positive impact on her client's financial well-being even in the absence of investments that outperform some market index. But, that is a sermon for another day, so let's focus on the whole question of outperforming markets and peers.

The investment world is highly competitive with a large number of well -informed participants who have significant resources at their disposal. So, how are you or your investment managers going to beat them? The answer is that some combination of you and they must have an "edge." We should begin the conversation by admitting that it is very difficult to gain an advantage or edge, and any leg-up may well prove fleeting. There is no shame in admitting that you don't have one, and that confession should lead to a passive approach to investing. But, if you are going to engage in active management, the first question is: what's my edge? Or alternatively, can I hire someone on my behalf who has an edge? In this paper, I explore the different kinds of edges that one can pursue and provide my own assessment as to their likelihood and durability. The purpose of all this is to help investors intelligently design their investment programs and to assist in the process of manager selection.

Three Types of Edges

I believe that potential edges or advantages fall neatly into three broad categories. The first two are relatively straightforward whereas the third is more difficult to define and articulate. And, to the extent that someone may have one in the last category, it will be particularly difficult to defend and maintain. The three categories are:

1. **Structural Advantages**
2. **Access**
3. **Skill**

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1 Structural Advantages

While certainly not assured, certain types of investors have structural advantages that may provide them with a leg-up on others. The first of these is a long time horizon. There are several investment categories that require a long holding period (timberland for example) that may well preclude participation by many types of investors with more limited time horizons. In theory, investments of this sort should provide a superior return because of the more limited number of potential buyers. A related strategy involves trying to capture the illiquidity premium which is the extra return that an investor should expect as compensation for giving up liquidity. This return is frequently associated with private equity, private real estate, and some natural resource investments, all of which require longer term commitments. Again, this premium is certainly not assured, particularly over short to intermediate periods. Finally, some investors are able to earn what is known as an origination premium. Specifically, some financial firms structure investments of various types and then sell a portion to other investors thereby earning fees in addition to the basic return on the portion retained in their own portfolio.

2 Access

A fact of life in the investment world is that some investors have access to opportunities that may not be available to others. First, by virtue of both regulation and the practices of investment firms, certain investment categories are not available to smaller individual and institutional investors. But, I wouldn't want to overplay this card because there are also diseconomies of scale in investing. Specifically, very large investors may have a difficult time putting large sums to work and even highly successful investments may not move the overall needle on a large fund.

Second, relationships are very important in investing. Top flight investment managers frequently do not accept money from new clients or limited partners because they have a number of long standing relationships that supply all of the capital required to implement their strategy. So, the investment teams at endowments, pension funds, and Outsourced Chief Investment Officer Firms (OCIOs) spend a great deal of time cultivating relationships with top flight investment managers as well as those that seem to have the capability to move into those ranks. One of the best examples of the impact of access has been the success of large endowments in building relationships with their alumni, many of whom run very successful investment management organizations. Endowments and foundations are also favored clients for many investment managers because of the perpetual nature of their funds and their internal expertise.

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At the manager level, some investors have what is known as "proprietary deal flow." Specifically, premier private equity and real estate managers among other categories see potential acquisitions that are not widely marketed which gives them a leg up on their competition.

3 Skill

This third category is particularly difficult because skill is very hard to define and measure. Return data doesn't provide much help because a very long track record is required to be able to demonstrate skill as opposed to luck. And, there are very few organizations/ funds that have been run by the same person or team long enough to pass the statistical significance test. But, given all of these caveats, I think this potential edge can be divided into three sub-categories:

- **An information advantage**
- **An implementation advantage**
- **An analytical advantage**

An Information Advantage

An investor would likely gain an advantage over the competition if she had information that was not available to others and therefore not baked into current security prices. While certainly possible, gaining this edge is quite difficult. First, there are very specific laws prohibiting the use of material inside information, and corporations are required to disseminate information to all investors simultaneously. Similarly, the announcement of government economic statistics is carefully controlled and leaks are quite rare.

But, there are some opportunities to scoop the competition. Many firms do their own economic surveys so they may in fact have information on the performance of the economy that is more up to date than reported government statistics. Similarly, good analysts do not rely solely on a given company for information on its performance. Instead, they contact suppliers, customers, competitors, trade associations, and so on. Finally, some analysts do research on companies that are not widely followed by Wall Street firms in the hope of digging up a nugget of information with significant investment implications. But, once again, a number of firms engage in these practices so there is no guarantee that the result will be a sustainable or even temporary edge.

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An Implementation Advantage

Shortly, we will get to the most interesting category which is analytical skill. But first, it is certainly the case that some investors are simply better than others at converting their investment insights into investment performance. This begins with the investment manager's decision process which should be well-defined and crisp. Investment decisions must be implemented in a timely and cost effective manner and good investors pay careful attention to trading which is particularly important for less liquid investments or large trades. For taxable investors, tax management is very important in determining after-tax returns. And for all investors, risk management is critical. As was the case with information, it is theoretically possible to gain an implementation edge, but it is difficult because most high quality managers engage in "best" practices.

An Analytical Edge

Most professional investors would argue that their edge falls in this category which is based on superior analytical ability. More specifically, consider the following:

- **New analytical techniques**
- **Proprietary models**
- **Superior forecasting ability**
- **Understanding of the direction of investor psychology**
- **Control of emotions**
- **Judgement**
- **Insight**
- **Experience**
- **Intuition**
- **Unconventional thinking**
- **Political savvy**

While these attributes are certainly real and some investors do possess them, they are obviously difficult to measure and somewhat ephemeral. Moreover, any advantage is difficult to maintain because the competition is an intelligent, highly motivated lot.

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How Do We Employ These Concepts?

First, in each asset category, we make a judgment as to whether we think we can identify managers with a sustainable edge. If the answer is no, then we generally employ a passive strategy to gain market exposure. At the other extreme, asset classes such as private equity and private real estate are all about skilled active management because the investment manager can have a material impact on return through deal flow, operational improvements, capital market transactions, and so on.

Second, when we do engage in active management, you can probably guess the first question we ask a potential manager; what is your edge? If the manager doesn't have a good answer or hasn't thought about the question, it will be a short interview. In addition to compliance with guidelines and other operational details, our ongoing monitoring process is also focused on the question of whether each manager is maintaining an edge. This is a very difficult call, particularly when things aren't going well. Has the manager lost her edge, or is she simply going through one of those inevitable rough patches.

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Ask Us the Hard Question!

To be fair, you should ask us the same question-what is Diversified Trust's edge? First, as previously mentioned, we try to be objective in our analysis and opt for passive strategies when we don't believe we have one. But, following the format used above, we believe we bring the following to the table:

Structural Advantage

- **Assets under management and the use of commingled vehicles bring economies of scale and cost management**

Access

- **Access to institutional grade managers at effective cost**
- **Access to premier private equity, real estate, and other non-traditional asset managers that are not available to investors that do not have established relationships.**

Skill

- **Expertise in a broad range of wealth management disciplines**
- **Track record of above average manager selection**
- **Expertise in portfolio structuring**

But, as mentioned several times, an edge is both elusive and fleeting so we will never be complacent and will continue to add resources to our firm.

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