A Psychological Profile of the Portfolio Manager

Have recent upheavals made the portfolio manager manic-depressive, a game player, or too much the organization man?

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Putting It in Context

What triggered you to write this piece? And how do you think it should be helpful to professional investment practitioners?

The article remains relevant today, although when it was written we did not have the terminology "behavioral finance." But as a quantitative-oriented investor, I knew that the psychological filter of the researcher found in physics and most sciences had to be evident in our field too. Hence, I wrote the article to test whether or not I could pull some new data together to illustrate the principles and to develop my own arguments with sufficient rigor to stand the critique of my peers.

The Psychology of the New Portfolio Managers

> The fundamental theorem is that when confronted with unstructured stimuli the person will impose structure on them in such a way as to reflect his own needs and impulses; the subject's responses therefore are expected to serve as guides to his private world of fantasy, his attitudes, fears, aspirations and the like.
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> —L.K. Frank, 1939

Many have examined the working milieu of the investment manager in an effort to explain increased market volatility. No attempt, to my knowledge, has been made to examine the mind of the portfolio manager, the investment decision-maker, to understand and deal with this new phenomenon. This article is such an effort.

If we understand the filters, hypotheses, and assumptions that the portfolio manager uses to make his decisions, we shall be better able to interpret his deviations from "rational." Furthermore, we should be able to improve job-related learning and establish environments in which the new managers can flourish.

Finally, the article hopes to stimulate serious research by competent psychology professionals in this field. The field is not overcrowded, deals with interesting people, has ample quantitative data, and, because such research should lead to more optimum allocation of investment resources, it should pay well. Investment organizations need help now in the selection, training, organization, and prediction of the behavior of their own professional staffs. An important social-science function is wide open.

A large number of friends, colleagues, competitors, and academics have contributed thoughts to this short piece. I have elected to preserve their anonymity so they can continue to be unfettered observers of the investment scene, a role I risk losing. An exception to this rule is my public gratitude to my associate, Alexis Belash, a frequent translator of my writings into English.

Environment

Markets have been harsh lately. No sooner had the Fisher and Lorie long-term equity return figure of 9.3 percent per year been published when a 25-year bull market ended in 1966. Total return of bonds and stocks has been near zero since then, depending slightly, but not much, on when you wish to take the measurement. No sooner had the brightest business school graduates flocked to the investment industry in the mid-sixties to make their fortunes on the frontier of change, but change it did, and for the worse. Not only were careers not advancing, but jobs were threatened in one economy drive after another. The final irony is that the academics' notion of efficient markets—the random walk for portfolios—became widely accepted. Attacked by markets, client, employer, and teacher, the investment manager has withdrawn into a catatonic state. When he recovers, he will exhibit new behavior patterns learned from his experience.

A portfolio manager has one overriding requirement: to invest for his employer/client to produce the highest expected return, without ever assuming so much risk that future investment might become impossible. This is pure game theory, which has been well tested on humans and pigeons.

A more recent variant of game theory holds that there is a "utility" or "moral value" of money. A player may assign weights to various outcomes that from an objective, impersonal standpoint seem irrational. These arbitrary weights can be detected by the statistician over long observation periods and reveal the motivations, needs, and desires of the player. In fact, after determining which weighting systems are player-related, not game-related, new effective rules and compensating systems may be employed. These can improve the outcome without changing the players or their own non-optimizing weight assignments.

It is not very difficult to see how these weightings have changed in actual practice. The old definition of a portfolio manager's job was centered on stock picking. If one picked profitable investments, the job requirements were met. Now, the determination of risk level has replaced stock picking. Furthermore, stock picking has fallen into such disrepute that stock selection is assumed to be nearly impossible. Consequently, the portfolio manager has had to orient himself in wholly new ways: toward risks, toward diversification, and, of course, to clients.

Disorientation and Change

Thus, the new portfolio manager has acquired some new assumptions about his world from the experiences he has had in the last decade.

He is willing to accept the efficient market hypothesis, at least in private with his peers if not yet openly with his clients. This two-tier difference between fantasy and reality is causing far more anxiety among portfolio managers than the other, more widely publicized "two-tier" condition.

The second assumption is that the client's needs are paramount in determining the level of investment success. In most relationships between a professional and his client, the professional is in the superior position because of his specialized knowledge and facility. Although that assumption was true of the investment profession in the sixties, the investment world is undergoing rapid change, and the professional relationship here is being revised as well. Job security is most important in considering the manager's assumptions. Through economy drives and reorganizations, skilled investment people have been thrust out into an unreceptive job market.

Those who remain have a message: you do not win by trying to be a hero; stay in the middle as an unnoticed team-player, and feed your family. It has long been recognized that short-term job considerations penalize creative work; hence the tenure system in academia. The investment manager had been threatened at his most critical level, his own survival, and he may have put his own immediate interests ahead of those of his clients. If so, he has lost the principal mark of a professional, his independence and his ability to completely represent interests other than his own even if they are in conflict with his own.

The portfolio manager has a number of lesser filters that may influence his thinking. He thinks that trends endure and can be identified early enough to be profitably exploited. He thinks his peers are smart and is willing to copy them almost without question. After all, most of them went to the same schools he did, he often eats lunch with them, and he even lives the same life-style they do. He thinks most of the world can be quantified—numbers count. But exhaustive study is not productive. He looks for the key reasons and is willing to forgo the luxury of more detailed and thorough analysis. Finally, he is motivated by the achievement of capital power. Few of the top portfolio managers are wealthy in their own right. Most are striving to achieve freedom of occupational choice by acquiring sufficient capital to meet a high living standard. Their personal options will be greater with capital than with merely a high employment salary.

Most investment organizations have undergone a tightening of structure in the last five years or so. It is assumed that this trend has emanated from senior management levels. I doubt it. Portfolio managers today manifest an interest in having well-defined limits to their decision-making, are happy with approved policy guides and in avoiding individual assignment of responsibility for investment acts that may go astray. Several former military men who came to the investment business say that change was far easier to bring about in their first career than in their second.

Much of the change in the investment world seems to repeat the Hawthorne experiment of 1927. Contrary to the hypothesis there being tested, changes in light level, first increasing then decreasing, *both* produced increases in assemblers' output. Changes in industry assignments, changes in portfolio industry mix, field trips to company managements have some similarity to change for the sake of job interest, not content.

The Protestant Ethic was accepted during the sixties; a lot of hard work and occasional flashes of brilliance would allow the portfolio manager to control his own destiny. Now that is not the case. His destiny is in the hands of a system that looks random or efficient, of an organization that is reducing its manpower, of a client who distrusts his mystical skills, and of a personal ego that requires he reject all of these notions. Is it any wonder that the portfolio manager has begun to embrace marketing?

Characteristics of a Portfolio Manager

The portfolio manager job requirements stated by investment firms have escalated to the point that one man cannot fulfill the task. No longer is a determination of future earnings above or below trend the principal ingredient. Now one is expected to deal with inflation, Washington, international affairs . . . all the things that were once taken for granted. Clearly a team is called for, and in a team individual responsibility is very difficult to assign. These long-term factors are also very difficult to connect to specific decisions, so that individual performance review is impossible. Decisiveness and frequency of investment decisions are not important now. The long-term issues change slowly and the decision points are fewer. Few decisions, few actions, long-term considerations, and a team effort.

One of the common psychotic states is manic depressive. This is a state in which the subject cyclically changes between excited and depressed. Although there are behavior manifestations of the manic depressive in all of us at one time or another, they seem to be more apparent in investment people recently. Perhaps the tight organization and even the willingness of investment people for structure is a voluntary recognition of the psychological damage and the need for repair. An application of game theory suggests a change in game rules to adapt the non-reality player-related weights to a profit system.

The exaggerated behavior of the game-player is not alone in revealing his characteristics and experience. His associations are also clues. Group behavior studies have much to tell us about groups that are threatened, even with very mild threats. Panic sets in when team effort is required and the group is not meeting its norm. There is a classic experimental game involving removing pegs from a bottle for a small reward or punishment. It frequently leads to violence on the part of the participants. Non-conformity is the worst threat to the group, according to most studies. Homans (1950) found in his study of gangs that the closer one came to the norms of the leader, the closer one became to him in rank.

Rumor plays a key role in the group. Information passed on serially gets abbreviated and altered until it is passed on by rote and has no information content about reality. The sharing of the same information, no matter how useless or incorrect, is important in preserving the group.

Punishment for non-conformity, sharing useless information, striving for the leader's norms are all ways of dealing with a hostile environment. They do not happen to be job-related in the sense of enhancing investment performance. Appleman (1973a, 1973b) gave a questionnaire to readers of the *Financial Analysts Journal*. He concluded that portfolio managers were demoralized, unable to be rational.

Learning

We have discussed some of the weaknesses of the present state of mind. The purpose is not to add to the excessive criticism of portfolio managers, but rather to illuminate some of their problems. Assistance could come in two forms: one, an increase in organizational structure to remove some of the threats and fears (this is occurring); and, two, a relearning of old experiences that may counter-balance the weight of the more recent negative ones. The latter exercise is promising.

One of the most widely publicized experiments in learning was the Pavlov (1927) demonstration of a conditioned response in a dog. By association with a pleasurable experience (satisfaction of hunger), a dog was made to salivate at the ringing of a bell. The traditional ringing of the morning bell on the floor of the New York Stock Exchange may be too much of a coincidence. It is not difficult to draw the analogy that when investment decisions produce less than expected results at the ringing of the bell, the subject will exhibit behavior demonstrating that he has "learned" something painful is about to occur. Since pleasure and pain are far more evenly balanced in the study of market history, I would remind the portfolio manager not to be unduly concerned with recent events.

In animals and, I suspect, in humans, the early learning experiences tend to dominate. Thus, a portfolio manager of the fifties and sixties would tend to exhibit behavior appropriate for a rising trend, and deviances from that environment will initially be rejected. Those of more recent responsibility will display skills useful in a trendless condition and are likely to be equally confused by change. A knowledge of market history will even out these biases. It would be especially useful if market games could be played, like computer-generated war games, to simulate earlier periods, thereby developing and reinforcing skills unused in the current market phase.

Rationalization is the most important defense mechanism in one's arsenal of protective devices. But rationalization hinders learning by blocking useful information. The more used in the short-run, the more it is likely to be required in the long-run, through encouragement of mistakes. There are a number of nonthreatening methods of criticism and learning that do not involve forcing someone to establish a pattern of rationalization and self-justification. Games are one example. They should be used.

The Future

This article is not intended to have foresight; the study of the psychology of the portfolio manager is too new for that. I have some views, however, and there are changes now taking place that need assessment.

My own preferred investment environment is one characterized by rigid discipline and a loose organizational structure. The investment community seems headed for the converse: a willingness to adopt a series of expedient philosophies and a tight organization. This trend may protect the psyche of the portfolio manager and keep him from doing great damage in his present wounded state. It does not get at the root problem, his mental state, but merely allows him to function in a limited way.

The view that marketing is the key ingredient of the investment process needs critical examination before its acceptance. This doctrine of marketing primacy is being taught in the leading investment courses and is a contributing factor to the disinterest of top students in investments today. Like many disguised norms, it has a way of bringing about its own fulfillment. As one identified with endorsing the efficient market notion, I would prefer to see effort devoted to production considerations, such as economies of scale, and to searching out those places and times in the market when inefficiencies are present. The practitioner has given up too soon—perhaps another manifestation of his present mental condition.

I recently read a prescription for group brainwashing: "Segregate leaders, deny information, create distrust by informers, withdraw group privileges because of one person, publicly praise collaboration, pace demands for conformity slowly so that resistance seems illogical, maintain deprivation, and give small rewards for conforming." Most of these conditions seem to be at work in the investment world in 1974, and like the results of most brainwashing exercises, they seem unlikely to be of benefit to a constructive enterprise.

Having stated, and perhaps overstated, my fears, let me close by expressing my hope. The forces I seem to see at work are not invincible. They can be resisted, and such damage as they may have caused can be repaired. A prerequisite for doing so is that they and their impact be clearly identified and understood. This article is intended as a modest contribution to that end. From its very inception, one of the fundamental tenets of the psychoanalytical movement has been that unconscious tendencies rendered conscious could be corrected where there was the will to do so.

Of all the major factors that affect the behavior of the stock market, the psychology of the portfolio manager is probably the most neglected. Whether or not I have managed to shed any light on this area, it is my hope to stimulate greater interest in it.

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