ArT LESSONS

Learning how to use creativity could give investors an advantage

By Ed McCarthy

Photography by Cade Martin

"Invest in what you know." That quotation is frequently attributed to Peter Lynch, the retired Fidelity Magellan fund manager. The myths surrounding Lynch's legendary stock-picking ability often focus on the sudden arrival of profitable insights when he was out shopping or at home with his family. But, as Lynch stressed in an early December 2015 *Wall Street Journal* article, that was only part of the message. He agreed that an investor's specialized knowledge could uncover profitable investments, but it was also necessary to support those insights with traditional, in-depth research.

But the quotation raises an important point: Where do creative investment ideas originate? Are investment managers at the mercy of serendipitous, eureka-like moments and automated screens, or can creativity be learned and inculcated in a firm's investment process?

A related theme is how we define creativity. Is creativity limited to the creation or discovery of a new paradigm, or does it also involve follow-up development within the new paradigm? A famous example from physics would be Einstein's theories on relativity—a paradigm shift—which then spawned voluminous follow-up efforts in the sciences. In finance, the original Black–Scholes model would be an example of a paradigm shift, with much of the subsequent options and derivatives research being in the follow-up category.

CREATIVITY AS A PROCESS

Many investment managers are neglecting the potential value of creativity in their work, according to Jason Voss, CFA, content director with CFA Institute in New York City. Throughout his career, Voss (who retired from his role as co-portfolio manager of the Davis Appreciation and Income Fund in 2005) has believed that professional investors need a guide on developing creative investment ideas, and for the past several years he has been working on such a book. *The Investment Idea Generation Guide*, published in December 2015 by CFA Institute, is initially being distributed as a benefit to CFA Institute members, although it might be offered for sale at a later date to non-members as well.

Most people, including investment managers, "rely upon their creativity to fire in a serendipitous sort of fashion," Voss observes. This would be the classic "aha moment," when several previously unconnected ideas come together in a cohesive pattern. For instance: sitting in the mall and realizing that the store where your daughters love to shop could be the next hot retailer for teens, you decide to research the company. Valuation screens for eliminating and highlighting potential investments in a defined category also serve as a proxy for investment idea generation, he says.

A common objection is that creativity can't be taught or learned—you either have it or you don't. Voss says that type of comment is typical and is born of an outdated mythology that was disproven about 15 years ago. Not surprisingly, many finance professionals are unlikely to be aware of research and developments in human learning and neuroscience. Current thinking in those fields has changed. "It turns out that creativity is a natural function of the mind; it's not a gift necessarily," says Voss. "There are certainly some people that are more gifted than others, but creativity is a natural function of the mind and there are things that you can do to cultivate it."

This idea of deliberately enhancing creativity has moved into the public sphere. Psychologist Mihaly Csikszentmihalyi's "flow" series, about channeling creativity through single-minded immersion in an activity, has been widely read. More recently, *Creativity, Inc.: Overcoming the Unseen Forces That Stand in the Way of True Inspiration* by Ed Catmull and Amy Wallace (Random House, 2014) has received solid reviews in the business press.

MAPPING THE MENTAL MODELS

Voss used an à la carte method with his book's content so readers can chart their own path through the material, but a foundational element is what he calls "taking stock of mental models." By definition, in his view, creativity is doing something that you have never done or combining things you have never combined. But "in order to know what you don't know, you have to make a good map of what you do know," he says—hence the need for deliberately reviewing mental skillsets and models. Voss cautions that the process sounds easy but notes that most of us have never taken a proper mental inventory of our primary and secondary skills. The *Guide* takes readers through that process, which is intended to help illuminate the interconnections between things the reader already knows and move the reader into new areas.

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He cites the example of an investment manager who wishes to generate emerging market investment ideas. In her spare time, she enjoys reading about history. Is there a way to connect a love of history with looking for opportunities in emerging markets? Voss believes it can be done. "I'd argue there's a fairly good chance that you could pick up a book about Southeast Asia—for example, read about its history and it might help you understand the region better—and ergo you may generate a new investment idea," he says.

Mental maps can also reveal potential blind spots. For instance, the mental-map review might cause an investment manager to recognize his lack of knowledge about and discomfort with derivatives. If the manager chose to overcome those blocks, learning more about derivatives would be a natural solution. As Voss explains, "In taking that mental inventory, which that exercise demands, and making a mental map of what you know, what you *don't* know oftentimes becomes very obvious, and it has a ready-made solution—get more information."

WORKING WITH SCENARIOS

Mind mapping focuses on creativity as a general tool. Scenario planning, the book's second major theme (and where co-author William C.G. Ortel contributed the most), provides a structure for unlocking that creativity and implementing it as a business tool. The process starts by considering predetermined elements in the current environment. These elements form the baseline case for each scenario. Demographics and birth rates are examples of elements that are unlikely to deviate from their current trends. Government actions can be another predetermined element. If China's government publicly commits to building, say, a specified number of highway miles, a project on that scale isn't likely to be canceled, so it can be considered predetermined.

The next step is to add uncertain events to the predetermined events, which can result in different outcomes and form the basis for scenarios. Essentially, scenarios are stories to which investment managers pay attention as they observe the world. Investment managers can also begin to test how different asset classes and positions are likely to perform in clients' portfolios should a specific scenario begin to unfold. If a manager recognizes certain parts of the scenario occurring, he or she will have a sense of each event's direction and can respond before others recognize the trend. This ability creates an opportunity to capture alpha that no one else recognizes, according to Voss.

Scenarios should not be confused with point forecasts or weighted-average outcomes. Those projections are numerically driven, while scenarios are qualitative narratives that don't carry outcome probabilities. "You just have those scenarios in mind, and you identify some of those harbingers that might indicate that a particular scenario is unfolding," he says. "It's a very different approach. It's almost the opposite approach to forecasting."

Voss points out that mapping and scenario planning are widely used, proven techniques, but in his experience, the investment management profession still relies largely on serendipity and valuation screens for creativity.

This writer's effort to find sources for this article supports Voss's contention. Prospective sources were eager to discuss the specifics of how they invest and manage clients' funds, but when informed that this article would focus on the creative process they followed to reach those investment ideas, the typical response was the online equivalent of a blank stare.

CREATIVITY WITHIN A FRAMEWORK

Valuation, growth, and liquidity: It's a frequently heard mantra when you speak with Lori Van Dusen and Joseph Zappia, co-chief investment officers at LVW Advisors in Pittsford, New York. The firm manages approximately US$3 billion of assets for ultra-high-net-worth and institutional clients. And these three criteria serve as the hurdles every proposed investment must clear before it reaches clients' portfolios.

The firm eschews the use of investing to fill style boxes or asset class categories and does not use screens, relying instead on multiple sources of creativity to find new ideas. Van Dusen and Zappia generate many of the proposals. Van Dusen spends the first part of most mornings immersing herself in news and research. The challenge is to find original thinking, because much investment news and research is based on other reports. That means looking at different networks, different countries, and different research providers. The effort requires constant focus. "I work on thinking about portfolio sourcing, ideas, talking to people every single day," she says.

Van Dusen believes her background as a trained musician benefits her creativity. It's about putting disparate pieces together "so that you really get something that sounds great, is orchestrated well, isn't diluted, isn't too noisy—that's a creative process," she says. "That's pattern recognition and putting a lot of different pieces together. That's how I think the better research people and investment people think. It's not about just filling buckets and following what everybody else is doing."

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The investment committee meets monthly. In between meetings, Van Dusen writes two or three internal memos each week to share her thoughts. Topics vary and can include observations about economies, markets, and current or potential investments. An early December memo discussed the idea of buying Brazilian debt, for example. The memos help maintain ongoing dialogues among committee members and often frame subsequent meeting discussions.

Other members of the investment committee also generate ideas. In addition to several of the firm's senior staff members, the committee includes a paid nonemployee adviser with extensive emerging market experience.

LVW's research department, which has four analysts, is another source of ideas. Zappia says that the analysts are encouraged to seek out "nuanced, interesting, and different" ideas that they can present to the investment committee. There is no bias in favor of or against prospective investments: "We ask them to be completely independent, on their own, and we've discussed [such] things as litigation, financing, life settlements, catastrophic reinsurance, static arbitration strategy—you name it," says Zappia. "None of these have made it into client portfolios, but the point is we encourage these young folks to start to build their networks and reach out and come to us with as many investment ideas as they can that they think could add value to the portfolio, either by [creating] alpha or differentiating returns or diversifying."

Scenario development is an important part of LVW's process for evaluating proposed and current investments. The scenarios aren't academic exercises, however. Their purpose is to help the firm understand potential impacts on client portfolios with the goal of improving results. Van Dusen gives the example of the Federal Reserve's much-anticipated decision to raise interest rates. The general consensus is that the Fed will raise interest rates slowly. But what happens to the firm's portfolios if the Fed acts more aggressively or if inflation is higher than anticipated? "We think about scenarios that way and run some plausible scenarios and then say, 'Are we sure that we really have a truly diversified portfolio if this were to happen, or does this thing suddenly become connected to this thing?'" she says.

This process has resulted in the inclusion of unconventional investments. For example, during the financial crisis, the firm recognized that European banks were not lending funds. LVW's response was to partner with an organization that had local expertise to develop a European distressed lending program that was hedged back to the dollar to eliminate currency impact. The program was successful and produced the investment results that LVW had anticipated. As another example, LVW's investment committee believes that emerging markets offer attractive potential, though not in the typical fashion of passively indexing into a country's largest companies. Instead, the committee is interviewing managers, including some based in Asia, who are running long–short fund strategies with a focus on emerging market consumers.

BEYOND BRAINSTORMING

There is a potential downside to creative investing, Zappia cautions. If the concept takes over the investment process, a manager could wind up chasing the currently hot ideas. Successful creative investing requires guiding the creative process and merging the resulting proposals into a clearly defined and enforced framework: valuation, growth, and liquidity in LVW's case. If an investment does not meet the firm's standards for each criterion, it won't get into (or will be removed from) the portfolio.

The investment committee at Denver, Colorado–based investment consultants Innovest Portfolio Solutions also applies a reality test to its creative inputs, according to Scott Middleton, CFA, principal and director of the committee. The committee consists of consultants who work with clients and key research staff. Each year, the firm updates its 5- to 10-year outlook for the economy and the financial markets. The process includes projections of investment returns for each asset class.

"Most of the creativity in our work comes from our analysts, who are reviewing these individual asset classes and examining them—not only how we used to do it, but also looking for resources to evaluate them in a different light or more thoroughly on a forward basis," says Middleton.

The firm encourages creativity, but "it has to be within the process that works for a client," Middleton cautions. "It's always a balance of encouraging creativity but also helping analysts to understand the bigger picture of implementation and the pros and cons of that." To help maintain that balance, analysts' ideas are vetted with respect to how they can be implemented and clients' potential reactions. He gives the hypothetical example of an analyst becoming excited about an emerging market investment theme's potential. When the consultants review the idea, however, they must consider how it will be recommended and implemented across client portfolios.

"From the analysts' point of view, they've come up with a great idea, but on the other hand … consultants know implementing it is a whole different story," he says.

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