

Emergence Theory and the Creation of a Superior Investment Advisor

Some would argue that there is a single person or a few individuals that are the critical people that inform a process, a culture in new firms. Alternatively, there are those that favor a free standing, existing culture (think any ex-Goldman or like spun off entity and all that that lineage purportedly suggests). I describe the two approaches as “Cult of Personality” and “Marquee Firm”. However, it is my view that there is a middle ground that makes much more sense: the founding personality must, through a highly cultivated approach, form a coherent, essential methodological tool, *and*, then set a culture that embraces it and the qualitative aspects of “who you are” as a firm. In stepping back and away from it, a firm with such beginnings can navigate strong seas due to these elements essentially wiring into its staff. In a sense, the methodology and culture becomes the firm’s *DNA*. With this DNA, the professional staff, working with a set investment methodology can create richer constructs – that is, that due to a birth that includes this institutional DNA, through the organization’s life, a Branded Franchise can be formed and *a greater and richer order will emerge*. In so doing, a properly conceived Start-Up can outperform both the Cult of Personality and Marquee Firm, and offer, perhaps greater stability going forward.

Emergence Theory

Okay, first, what the hell am I talking about? Emergence can be defined as the “arising of novel and coherent structures, patterns and properties during the process of self-organization in complex systems”.¹ While this might be the way wind and ocean create ripples in the sand, it’s also about the unique way in which ants build a colony or conduct work with an efficiency and insight that seems incomprehensible given the limits of their thought processes (there’s a whole body of work on Ant Colony Optimization). An emergent behavior or emergent property can appear when a number of simple entities operate in an environment, forming more complex behaviors as a collective.



Why is their behavior not chaotic?

Emergent structures are patterns not created by a single event or rule. Nothing commands the system to form a pattern. Instead, the interaction of each part with its immediate surroundings causes a complex chain of processes leading to some order. One might

¹ Corning, Peter A. (2002), The Re-Emergence of “Emergence”: A Venerable Concept in Search of a Theory”



conclude that emergent structures are more than the sum of their parts because the emergent order will not arise if the various parts are simply coexisting; the interaction of these parts is central. This is why I'd argue that the organic way in which we are growing our new firm can help us outperform both Marquee Firms (that often lack a coherent dynamic institutional methodology despite outward appearances) and the Cult of Personality (that moves solely in the direction chosen by the theoretical messianic leader).

Cult of Personality, Marquee Firm and the Start-Up

Given these alternatives, most hedge fund investors have strong preferences. The Cult of Personality investor believes that betting on the messianic individual – one that somehow always seems to find a way to make money, or see trends first, is the way to go. Others don't want any surprises, good or bad, and think they get more stable and defensible returns from the Marquee Firm. With some exceptions, few investors prefer the Start-Up due to business risk (i.e., business failure), though myriad studies suggest that's where you'll find outperformance. Let's discuss what's flawed in these preferences.



Atlas carries the heavens on his shoulders - this can't end well

The Cult of Personality firm has risks of significant business dysfunction. While the messianic figure continues year in, year out, whole organizations can come and go with regularity due to the leader's misbehavior and unsupportable decisions. While there is business risk in this culture, investors often justify their allocation to such managers based on historic performance of the firm. Often what is not captured in the performance is the better risk-adjusted investment ideas brought by ignored staff that might have been additive in good years or mitigated losses in bad ones.





“What’s Good for General Motors” – The Marquee Firm’s Headquarters Circa 1960 - This Didn’t End Well

With the Marquee Firm, leadership can be so entirely disconnected from performance that results are routinely mediocre. In some instances the Marquee Firm may care little if at all, in the development and perspective of its personnel as the institutional priority may be protecting “Franchise.” With compensation largely driven by management fees on colossal AUM and/or massive assets riding beta, investors get exactly what they ask for here – plausible deniability – if the Marquee Firm underperforms or fails, the investor cannot be blamed for choosing them.

New firms are disregarded by most investors. Why? *Did investors choosing either the Cult of Personality or Marquee Firm in 2008 avoid the abysmal performance and risk of their business failure? Didn’t 2008 suggest there is business risk regardless of the purported personality or Marquee stature?*

Institutional DNA

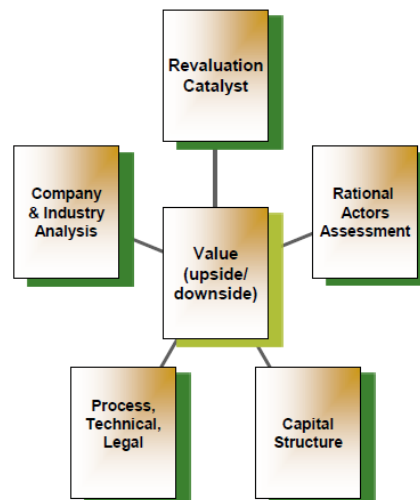
In an organism, DNA functions as the information molecule within a cell. DNA is a nucleic acid that contains the genetic instructions used by all living organisms.

For us, the *Institutional DNA* should be composed of a coherent investment methodology, the system of interactions and checks in order to make investment decisions and the qualitative culture that foment these interactions in a desirable way. Inevitably Institutional DNA is formed as a function of the personnel and leadership interaction. For better or worse (and I don’t attempt any subjective judgment here), there are either coherent methodologies or highly personalized individual approaches. The methodologies are either respected or not, consistent or not. Culturally, personnel will interact, share ideas, defend and refine ideas in that way that either is enforced from the beginning or evolves out of the mix of the diverse personalities. Neither is right or wrong. Having worked in all sorts of organizations in my career, it is my view that the clearest path to a successful and stable investment advisor calls for a clearly defined investment methodology and operating culture.



The Coherent Investment Methodology and Impact of Emergence on its Approach to “Perfection”

The “Five Pronged Methodology”² is our investment approach, one I’ve burnished over nearly twenty years of investing. At Tiburon, it is taught, studied, refined and the linchpin of our reason for being. With all investment ideas reviewed through this lens, discussed thoroughly by the team and portfolio manager, over time, the language of the methodology, the rudiments of each element, develop a richer and richer organizational literature. Through the team’s write ups, discussions, performance, we come to know this methodology better and refine, elaborate and expand in the nuance of it. The team must buy into the methodology. In so doing, we all become practitioners. Like organisms in a system, there exists a shared goal achieved with developing collective knowledge and experience, forming an institutional memory. Like asymptotic expansion in mathematics, we can never achieve “perfection”, but can improve with each passing day, month, year; the aggregate skill base of an organization improves in ways not captured by firms with less rigorous or un-codified methodologies, or silo-ed professionals in Marquee Firms with no interest or incentive to improve *together*.



Tiburon's Five Pronged Methodology

The Five Pronged Methodology is part of our firm DNA and is the basis for how we put money to work. The team’s ongoing use of this methodology, interacting in ways informed by the firm’s culture (also part of the firm DNA), moves the skill-set of the personnel beyond the sum of its parts. Our Five Prong Methodology is a coherent and methodical evaluation formula that gives room for the richness of learning yet is systematic enough to avoid the sloppiness in thinking that can occur with more self-directed and organic approaches.

² For a detailed discussion of the “Five Prong Methodology, see: <http://www.distressed-debt-investing.com/2009/09/exclusive-interview-with-hedge-fund.html>



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If the Five Pronged Methodology provides the “bones” of the investment process, the people utilizing it, and interacting produce a richness around it that affords everyone unlimited freedom - just within the framework. In the practice of our trade, all of us make each other better, see connections we’d not once seen, develop ever more intricate ways of considering each of the five prongs, etc. To think that a codified and specific system is narrow and stifling would be dead-wrong. In fact, arguably a system that we all utilize, with its varied elements provides a framework within which to work, that is actually *liberating*. The excitement of this is that over time, like a wine or stew, the flavors get more intricate and special.

My argument is that a firm with Institutional DNA, regardless of scale, regardless of the messianic personality, will perform and stand the test of time. In both forms of organization, personnel can feel disconnected from the direction and performance of a firm. This is not good. With a defined methodology and refined culture, every person can impact the development and direction of the organization. In so doing they are granted the gift responsibility. When people are made responsible for their work as it impacts the whole, they rise to the occasion. In so doing they grow. This is at the heart of *Emergence*. I will argue that my team, my firm, the collection of professionals that make up the whole are greater than the sum of the parts. The collective work, in the carefully crafted framework of methodology and culture leads to better decisions made for the combined good. And isn’t this specifically what is called for – a community of interest among the investment professionals and the firm’s investors?

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