

OUTSIDE THE FLAGS

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MasterChef of Investing

In the popular TV program MasterChef, contestants face a series of cooking challenges. From low quality ingredients to inadequate preparation to poor implementation, so many things can, and do, go wrong. It's a bit like investing.

In the world of investment, there customarily are two broad approaches. The first of these is a traditionally active one where managers attempt to find mispriced securities or seek to time their entry and exit points from various parts of the market.

This first approach is akin to the challenge in MasterChef of having to invent a new and distinctive dish within a set time frame. The apparent advantage for the chef in this challenge is flexibility of concept.

But what usually happens is that once they have committed to their chosen recipe, the chef ends up racing against the clock and is locked into particular ingredients to create

a single dish. Of course, it may work out, but if they lose attention for a second, the dish is ruined and they have nothing to fall back on.

Likewise in the investment world, the traditionally active manager locks in on his best ideas. He thus finds himself with little flexibility to move and is constricted by time as he is trying to trade on information he believes is not yet reflected in prices. If it doesn't work out, he may not have a Plan B.

If your primary goal is standing out from the crowd, you are going to build cost and complexity into your process. In the cooking analogy, the price of your ingredients (out-of-season avocados for example) is going to be a secondary consideration to having an impact. And once you're committed to your distinctive dish, you may not be able to change tack.

The second approach in investing is when the investment manager seeks to track as closely as possible to a commercial index. The goal here is *not* to stand out, so the manager will be most conscious of "tracking error" (deviating from the benchmark).

This approach is more akin to the challenge in MasterChef in which contestants have to cook a standard popular dish with set ingredients. The focus in this case is not creativity, but following a set process as dictated by an outside party.

The ostensible advantage of the second approach is the chefs don't have to conceive of something completely new. The ingredients (or securities in the case of the investment manager) are known and it is just a matter of assembling them.

But the drawback of this latter approach is the absence of flexibility. The contestants can't substitute one ingredient for another (or one stock for another). The recipe must be followed as set. What's more, it must be achieved in a set timeframe.

The other disadvantage of this dictated menu is that it may not suit the clientele. For instance, it may be the world's best lasagna recipe made perfectly to order, but if your diners don't care for Italian food you have a problem.

But what if we had a system that combined the creativity of the first approach with the simplicity of the second? In this challenge, the focus shifts from being different for its own sake or following someone else's recipe to drawing from a range of ingredients to produce a diverse menu suiting a range of tastes.

In this third approach, our contestants do not face unnecessary constraints either in terms of time or ingredients. Instead, they assemble a broad selection of

dishes from multiple ingredients suitable for the season and at times of their choosing.

The difference under this third way is that the chefs are focusing on what they can control and are eliminating elements that might restrict their choices. Their ultimate goal is to efficiently and reliably provide meals that suit a range of palettes.

In the world of investing, this third way is the optimal approach. Picking stocks and timing the market, like making brilliant-off-the-cuff meals in all conditions in an efficient and consistent manner, is a tough ask even for the masters. Cooking meals off a provided menu, like the index managers, can be inflexible and costly.

The third way is akin to the Dimensional approach. We don't have to outguess the market to get a good result. We don't have to lock in on a couple of our best ideas and hope they turn out. But neither do we have to throw up our hands and contract the job out to a commercial index provider.

We can research the dimensions of expected return, design highly diverse portfolios that take advantage of those premiums and build flexibility into the system so that we efficiently and reliably serve up investment solutions for a wide range of needs.

Call it the MasterChef of investing.

The author would like to thank [Marlena Lee](#) for her inspiration for this article.



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