Perfection occurs "not when there is nothing left to add, but when there is nothing left to take away."
—*Leonardo da Vinci*

From Star to Founder EastRock

Portfolio Goals: Let There Be Nothing Left to Take Away

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HAVE YOU EVER WATCHED a CNC machine carve something beautiful out of a rough block of metal? I find this process of creative subtraction mesmerizing. Years ago, when I explained my firm's investment in a CNC company to my young nephew, he immediately understood that CNC technology could be used to make next-level skateboards. He was later proven correct when the entertaining Titans of CNC dedicated a TV episode to machining the first "aerospace isogrid skateboard" out of a hunk of aluminum.

Research by an interdisciplinary team at the University of Virginia shows that the human brain is biased to search for additive, rather than subtractive, solutions to complex problems. It's a default response. "Additive ideas come to mind quickly and easily, but subtractive ideas require more cognitive effort," explains one of the authors. "Because people are often moving fast and working with the first ideas that come to mind, they end up accepting additive solutions without considering subtraction at all."

The result? “Creation by Subtraction” is underutilized. Sure, the tech industry, where designers obsess over removing clutter in all its forms, is a notable exception. But in many disciplines, including our craft of investing, the role of creative subtraction is not much talked about. My hope with the following article is to start to change that.

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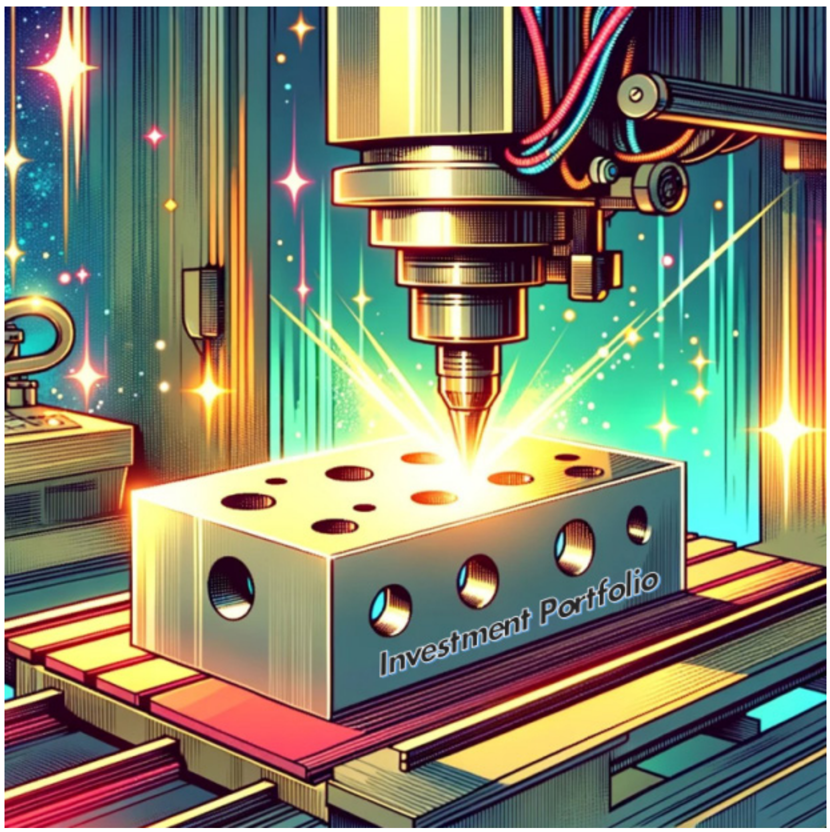
Let’s take a CNC machine to a typical institutional or family-office investment portfolio and see what we can drill away.

Our target? Let’s call it “Filler.”



For simplicity, let’s assume our portfolio consists of two materials: High Conviction Investments we want to keep and Filler we want to drill out.

Unfortunately, spotting Filler isn’t easy. Typically, Filler investments aren’t patently horrible. They are just mediocre. They lack edge or special characteristics. They can succeed sometimes, but the skew of their potential outcomes is underwhelming.

Filler is also hard to isolate. In portfolios that rely on third-party managers, Filler can find its way into funds that otherwise appear to be attractive allocations.

Before we talk about how to eliminate Filler, let's first talk about some of the reasons Filler shows up. When high-quality firms produce Filler, the following conditions tend to be present:

1. **Excessive Diversification.** To put it simply—the more investments a fund makes, the more Filler it is likely to have. Large PE funds make an average of 21 investments per fund. Assuming a 2-4 year investment period, they are making 5-10 new investments per year. That's too many if the goal is to keep the bar high. The proof is in the results—large funds underperform smaller funds, which average 10 investments per fund.

2. **Participation Trophies.** Investment firms have their politics, and part of keeping everyone happy is allowing everyone to contribute. In some cases, this produces "Hammer looking for a nail" investments—i.e., deals executed by sector-focused teams that want to be active despite a weak opportunity set. In other cases, partners with lower standards slip deals under the bar rather than over it.

3. **The Next Fund Is Calling.** To begin raising a new fund, a PE firm typically needs to invest a threshold percentage of its current fund. As the prior fund approaches the threshold, the firm may feel pressure to get across the finish line, especially when the fundraising environment is favorable. In these circumstances, we've seen PE firms execute their most Filler-like deals.

The conditions above can produce Filler within individual fund investments. But sometimes entire fund allocations can become Filler. Here are two scenarios to watch out for:

1. **"This Is Not What I Thought."** Allocators like to be known as long-term investors, but private equity allocations with long investment periods and hedge fund allocations with long lockups make it difficult to respond when High Conviction Investments turn to Filler. Unfortunately, we see this happen more often than one might think, so long-term commitments must be viewed with caution. In most fund documents, LPs are not well protected from changes in GP personnel and behavior. Risks include: i) extreme style drift; ii) changes in work ethic; and iii) loss of key team members (Key Man clauses notwithstanding).

2. **Bucket Filling.** An asset allocation strategy that involves filling standard buckets is likely to add Filler to any portfolio. Just because an asset class sounds "standard"—in the last decade, strategies such as hedge fund macro, emerging markets private equity, and core real estate come to mind—doesn't mean it offers an opportunity to add edge, non-correlation, or improved risk/return to your portfolio. If it doesn't add these things, it's Filler.

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The discussion above offers clues in the search for Filler. But how do we identify it for sure? And how do we drill it out once discovered?

There is no perfect answer, but it starts with creating an investment culture that is fundamentally intolerant of Filler and committed to evaluating investments based on edge and special value-add.

What also matters tremendously is the "who" and the "how" of partnering with external managers. On that front, our focus on smaller investment firms (which tend to have less over-diversification, participation politics, and drift) and our collaborative approach to partnering with early-stage firms make a world of difference.

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In today's world of advanced statistics— Moneyball and beyond— I've noticed a growing trend of evaluating managers based on measures such as batting average and slugging percentage. As a statistics geek myself, I applaud this trend. But stepping back for a moment, there is something special about eliminating Filler as a portfolio goal because it's likely to improve every statistic that matters. For managers of family and institutional portfolios, that should be quite an incentive to go drilling.

East Rock Capital

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