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Maybe Listen To The Outsider? He Sees Risks Differently

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"Ahmed Zayat was ready to sell. 152 one-year old horses were set to go to auction and included among them was one of Zayat's Thoroughbreds that did nothing to separate itself from the herd. Professional horse scouts—"Bloodstock Agents" in the vernacular—had used their traditional pedigree analysis and stopwatch times to conclude this particular horse's future didn't appear remarkably bright. But there was one problem. Zayat's own people were begging him not to sell. They'd utilized a different methodology, one born of data and statistics rather than "gut feeling" and Jeff Seder's team said all of those so-called experts were wrong. Approximately three years later, this horse, then known as American Pharoah, delivered on the team's expectations by becoming the first horse to win the Grand Slam of Thoroughbred racing—the "Triple Crown" as well as the prestigious Breeder's Cup Classic. What did Jeff know that everyone else didn't?"

A Horse of a Different Color

If one boils down the definition of risk to its most fundamental premise, it is this: not knowing. Risk can be that faulty brake line in a car, that brick dropped from a rooftop or that person with infidelity issues. If one had only *known* about those hazards, he or she would've simply fixed the line, crossed the street or avoided the cheater. But the lack of knowledge of such dangers is the primordial soup from which risk arises.

In the investment world, scholars have been seeking to tame risk for centuries. They've attempted to *know* risk by ascribing labels to the various types and amounts in the market. In so doing, the variety and intricacy of these metrics multiplied. As examples, they can be as common as Beta or ROI, as precise as the FCFE Ratio or as ghoulish as the Unclaimed Corpse Indicator. It's almost as if there's too much information available. In turn, these measures were then taught with authoritarian gravitas at universities. An unfortunate result? At the most selective investment firms, a person can't get hired without a degree from a small handful of prestigious universities that teach risk analysis like this as gospel.

The problem with this? Everyone's looking in the same direction. They're all learning to apply the same metrics and approaching risk the same way. They're focusing their attention on the brake pads and ignoring the brake line; they're fixating on the open manhole ahead and missing the falling brick from above; they're interrogating a date about his or her salary and ignoring the tan line on their ring finger. In effect, they're looking at the wrong risks…because they don't know the correct risk to look for.

Spring from the Gate

Different results require different thinking. Jeff Seder *knew* this. His work's initial focus involved the U.S. bobsledding team. By combining a mind for data and these unique lessons learned from his previous experiences, he approached horse racing from a new vantage point. Rather than lineage, he followed the data and isolated the size of a horse's left heart ventricle as a fantastic predictor of success. It was groundbreaking in its audacity. But he wasn't the first person to upend a world he wasn't classically trained in. Far from it. In fact, "Outsiders," or those with little formal training in their chosen field, have often proven to be some of the best innovators. Precisely due to their lack of indoctrination, these disruptors don't fall into the common traps of conventional thinking and, in fact, their ideas are often initially met with scorn.

Only a small selection of examples include:

Name	Training / Specialty	Impacted Field / Profession	Innovation
Jeff Seder	Data	Horse Racing	Introduced metrics / size of horse's left ventricle rather than relying on established breeding conventions.
Ignaz Semmelweis	Obstetrician	Germ Theory	Introduced hand washing in the mid-1800s and reduced maternal mortality rate by 90%. His efforts were mocked, he was sent to the asylum and he died there.
Elon Musk	Computer Programming	Automobiles, Space Exploration, Flamethrowers	Created first software at the age of 12. Pursued Physics and Business in college. Used knowledge to create companies dedicated to Electronic Vehicles and Space Exploration.
Billy Beane	Baseball Player	Data-driven Managership	Turned Oakland A's into one of the most cost-effective baseball teams. Revolutionized the evaluation of players in sports.
Girolamo Cardano	Medicine	Mathematics, Probability Theory, Medicine, Mechanics	One of the founders of algebra and probability theory, and first to systematize negative numbers. Also, the first clinical description of typhus and major contributions to hydrodynamics. Accused of heresy, imprisoned, and lost professorship.

Avoid the Einstellung Effect?

Historically, one of the most important metrics in horse racing has been pedigree. When you think about it, a horse's lineage is often one of the first things to be presented as proof of its abilities in common conversation. Yet, think of this same metric in any other sport. For every Manning quarterback that produced careers as good as their father's, there are untold numbers of progeny that wash out in the pros or never even make it there. So why does the sport of horse racing stubbornly cling to this metric?

The reason is *Inflexibility*. It's a particularly insidious problem that infects "Insiders." Put simply, it's a rush to judgment based on previous experience that prohibits the exploration of new thinking. Studies have shown that Insiders are far more prone to this trap, the Einstellung Effect, than Outsiders. And this often explains many of the innovations made by people who weren't formally indoctrinated in a chosen field.

Julian Koski and Armen Arus like to say they have one university degree between the two of them. It's a point of pride, in fact. They weren't trained in the traditional mindsets like the vast majority of those working on Wall Street. They didn't establish New Age Alpha, or their previous company, Transparent Value, to be another drab, uninspired asset management firm. They wanted to reframe the question of risk in its entirety and divorced themselves from traditional Wall Street risk metrics. Instead, they drew on the principals of insurance to completely reimagine the investment business. They saw the failure in asset management for what it truly was: a myopic tendency by Wall Street to focus on measures that identify uncertainty rather than focusing on the mother of all risk—Human Behavior, which they believed leads directly to loss.

It's the risk of human behavior. This decouples stock prices from their underlying fundamentals. It's a risk that cannot diversified away, only avoided. Put simply, investors have always attempted to pick stock market winners, but such an approach is archaic, unsystematic, and unpredictable. Recognizing that investors impound vague and ambiguous information into their investment decisions at all levels of the market, they reimagined asset management to attempt to strip out this risk. Julian and Armen discovered an innovative path that can unearth a new form of alpha by simply avoiding the losers.

In retrospect, it feels so obvious. Like measuring the size of a horse's heart rather than its family tree.

About Us

New Age Alpha is ushering in a new age of asset management by applying an actuarial-based approach to investment portfolios. Utilizing these principles built by the insurance industry, we construct portfolio solutions, indexes, and tools that aim to identify and avoid a mispricing risk caused by investor behavior. Embedding well-established principles of probability theory in our investment methodology, we construct solutions that aim to avoid mispriced stocks in a portfolio—losers. We combine the alpha potential of active management with the advantages of rules-based investing to build differentiated equity and fixed income portfolios that drive long-term outperformance.

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