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Checklists

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Simple checklists have been shown to be a good antidote against ineptitude. Research has shown that checklists reduce error rates in intensive care units. A simple checklist used by John Hopkins hospital reminding doctors to wash their hands and use antiseptic before operating on patients prevented infections, saved several lives and millions of dollars in costs. Checklists are also used by pilots, process engineers, the military and hiring managers to improve decision making by eliminating errors and biases.

In any complex system where human judgement is required, working with a checklist is a systematic way of ensuring that important conditions are met. Doctors who forget to use antiseptic or wash their hands before seeing patients are not sceptics of germ theory, they are simply victims of human forgetfulness.

The world is much more complex today than it was a 100 years ago. A plethora of data and methods of analysing it coupled with ever present human fallibility means that asset management is another industry where checklists can improve decision making.

When searching for active funds, one ideally wants a fund that is **cheap**, ***predictable*** *and* ***good***. Measuring the cheapness and predictability of an active fund manager is easy because these are objective values that can be quantitatively measured. Measuring the 'good' is much more difficult because it contains some qualitative qualities that can't be precisely measured.

When you buy a passive fund, you are buying a basket of assets. When you buy an active fund, you are buying a basket of assets plus the (hopefully) superior decision-making skills of the active manager. While past performance is not a guide to future results, success leaves traces. In the long term, superior decision-making skills should show up in the numbers through excess returns. However, a caveat must be added – the excess returns should be generated without taking excess risk. This, in finance jargon is known as having superior risk adjusted returns. 'Risk' here is usually measured as volatility.

Using volatility as a proxy for risk, one of our 'riskiest' holdings would be the Finsbury Growth and Income Trust. It is a concentrated fund by most standards therefore there is a larger swing in its daily value making it 'riskier'. This, to us, is a perverse way of measuring risk. The Finsbury Growth and Income Trust invests in reasonably priced companies with strong brands. A company with a strong brand is one that can influence consumer behaviour without competing on price. Companies with strong brands have metaphorical contracts with their customers which are a source of sustainable cash flows. This is an example of a good fund with a good process whose risk cannot be measured by looking at the volatility of its returns.

Generating good returns with a poor process is simply a sign of good fortune and this is not an intelligent way to invest. When looking for a good fund, one is essentially looking for a fund that has a good process. In the long term, this should show up in the numbers through superior returns.

In a world of ever-growing complexity, it is important to filter the signal from the noise and work with checklists to reduce errors and bias. Checklists have been successfully used to save lives in medicine. They can also be intelligently applied to asset management as an aid to human decision making, not a replacement.