THE RED X: MANAGING THE OUTLIERS IN THE INVESTMENT FIRM

By Jim Ware, CFA, and Keith Robinson, Focus Consulting Group
“It is the long-term investor, he who most promotes the public interest, who will in practice come in for the most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion.”

John Maynard Keynes

The management of active investment shops is a paradox. Simply put, as Keynes captures on the left, talented investors don’t want to be managed! The very thing that makes them extraordinary—their contrarian nature—puts them against authorities. We have seen this phenomenon so often in active investment shops that we have become suspicious of any alpha-producing teams that don’t face this challenge! The goal is to manage the creative tension that exists within the investment process, rather than the misguided outcome of aiming to eliminate it.

LET’S TAKE A CLOSER LOOK AT THE ISSUE. It’s the Monday morning Investment Committee meeting and you are sitting with your Senior Portfolio Managers: Andy Warhol, Truman Capote and Mick Jagger. You’re trying — yet again — to get them to work together for the benefit of the client. You’re confident that each could deliver using their own unique talents, but how do you leverage their talent for the sake of the team/firm? A core value for investment professionals is creativity, and this value attracts eccentrics as described by Keynes above. The mind that can see around corners and out-forecast the consensus is the stuff of genius. And like the famous characters of the artistic world—many of these investment geniuses are truly unique. Interestingly, one of the most famous investors—Warren Buffett—appears to be as normal as Coca Cola or IBM. The exception that proves the rule.

Culture is the bedrock on which firms are built and investment leaders are the creators/stewards of the culture. An investment leader’s challenge is to attract, retain and manage these brilliant investors in a way that aligns with the culture of the firm. These mercurial geniuses only partially align with the firm’s culture, but often deliver significant value. In this regard, we have coined a term “the Red X” that resonates with investment professionals and seems to have taken on a life of its own.

We define the Red X as the brilliant investment professional, who clearly adds value, but lives outside of some, or most, of the core values of the firm. In simple terms, the Red X is disruptive and can be toxic to the firm’s culture. The diagram below shows a hypothetical firm’s culture, represented by the values in the circles, and the behavior of the Red X, which is outside two of the core values.

This hypothetical case is common in the investment world: the Red X practices two of the four core values: integrity and excellence. He is ethical in his work and he adds alpha. However, this same person is not seen as respecting or trusting his colleagues. And he is not a team player which undermines the long-term effectiveness and overall success of the team.

One of the textbook Red Xs we encountered managed an equity fund. His ability to manage money was undeniable; fund performance was excellent for 1, 3, and 5 years. Analysts praised his skill: “given the choice of having George Soros or our PM manage my personal money, I would choose our PM.”

Genuinely high admiration, however colleagues acknowledged the challenge in working with him. We sat down with our Red X who explained a key personal philosophy to us: “life is a series of conversations, and every conversation has a winner and a loser, and I am never the loser.” So much for
teamwork! Every encounter has a win/lose outcome. (Our view of teamwork is that each member of the team is looking for win/wins when possible.) Behavior aside, his skills were recognized by three separate tours of duty with the same firm. In other words, hired then fired, re-hired then fired, re-re-hired and then they called Focus Consulting. (Can you hear the “Mission Impossible” theme song? This firm admitted to living out the definition of insanity: do the same things and expect different outcomes.) Such is the temptation with the Red X.

SNAPSHOT OF A RED X To further define the Red X, consider the protagonist in Michael Lewis’ fine book, The Big Short. Michael Burry is described as autistic, one-eyed, and annoying to even his closest friends. But his investment track record is outstanding:

“A person who had money with him from the beginning would have enjoyed gains of 186 percent over the six years, compared to 10.13 percent for the S&P 500.”

And Michael Burry fits our definition of a Red X. Here is what Lewis writes:

“He wore the same shorts and t-shirts to work for days on end. He refused to wear shoes with laces. He refused to wear watches or even his wedding ring. To calm himself at work he often blared heavy metal music … He was acutely aware that a great many of the people who had given him money now despised him. The awareness caused him to (a) withdraw into his office and shout “F@#%!” at the top of his lungs even more than usual; (b) develop a new contempt for his own investors.” Humorous descriptions of Burry are scattered throughout the book.

Our own experience of Burry aligns with his odd reputation. Early in 2011, we were on the same speaking agenda with Burry for a trade conference. We were of course excited about meeting this now-legendary figure and hearing him present. The upshot (as we heard it): Burry did not show up for the conference! And did not notify the host. Of all the possible behaviors to confirm Red X status, Burry chose the top one! An eccentric no-show.

What is the impact of a Red X? After all, if a brilliant investor were just a bit odd, there wouldn’t be a problem. We can all live with some peculiarities if we get gains of 186 percent! So, to be clear we are not talking about brilliant investors, like Warren Buffett and Peter Lynch, who seem to live quite normal lives (for billionaires). We are addressing the toxic Red X—dubbed the “Brilliant jerk” by Netflix. True Red X’s are incendiary devices that go beyond creating heat; they burn a culture to the ground. In fact, Christine Porath and Christine Pearson have researched this topic and found these toxic effects associated with Red X’s (see chart below).

Clearly, the productivity costs of Red X’s are a serious cultural and financial matter for a firm. Perhaps this is why investment leaders seem to resonate so strongly with the concept of Red X: they know that these people are a central concern in the successful management of the investment firm. In fact, feelings can be rather raw on this point.

Presenting at a dinner for investment leaders in Boston, we stated our case about the Red X and its consequences, then asked, “So, what is to be done with the Red X?”

Immediately, a CEO sitting to our left jumped out of his seat and shouted, “You ride that horse for as long and as hard as you can!” The room erupted in laughter, but an instant later two more CEO’s stood up and exclaimed with equal passion, “If you do that, you’ll ruin the organization!” So, who is right? How does the investment leader manage a Red X?

One investment CEO in the U.K., was wrestling with this Red X issue and asked us
to come and discuss it with the senior team. This CEO had informed us that the Red X phenomenon existed at the partner level, the very group that we would be meeting with. So, after explaining our Red X terminology to the senior partners, we asked them to evaluate themselves using our real-time polling devices. The question below was put to the group of ten partners, with these results:

**How many Red X’s are in this group?**

<table>
<thead>
<tr>
<th>NUMBER OF RED X’S</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>PARTNERS</td>
<td>30%</td>
<td>30%</td>
<td>40%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
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</tbody>
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The polling results indicated that four of the partners believed there were three Red X’s in the senior group, three believed there were two Red X’s, and another three believed there was one. In short, all the partners agreed that the group contained at least one Red X. (Our data from the industry indicates about 85% of investment professionals believe that Red X’s exist in their firms.) The next question we put to the group:

**Do you consider yourself a Red X?**

<table>
<thead>
<tr>
<th>PARTNERS</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARE YOU A RED X?</td>
<td>Yes No</td>
</tr>
</tbody>
</table>
2. **Fret about ’em.** This approach may be even worse than #1 because it burns time and energy. Keep track of how much time you waste talking about a Red X and you will see the importance of dealing with the issue.

3. **Fire ’em.** Often this response is the only one that works. Some Red X’s are resistant to any coaching, arguing that they’ve been wildly successful, so why change anything. These Red X’s may need to find a home where “anything goes” and they can be as eccentric as they please.

4. **Firewall ’em.** The idea here is to strip them of any managerial responsibilities and move them as far away from other team members as possible. Given a role in which the Red X can contribute without much team involvement, say as a strategist, this can work.

5. **Fix ’em.** See below.

Before discussing some solutions, let’s look at how most investment firms address Red X’s. The chart below shows the survey results of nearly 200 investment professionals. They were shown the five options above and then asked, “What is the most common way that investment firms deal with Red X’s?”

![Most common way of dealing with Red X](chart)

Not surprisingly, the most popular approaches all contain a strong theme of “Denial!” So, what can be done? The Fix ’em option involves a willingness to change on the part of the Red X. The person’s relationship to feedback is the key to this solution. The Center for Creative Leadership asserts that the number one skill of top executives is “learning agility.” This skill involves a person’s openness and receptivity to feedback. People who seek out and explore feedback tend to be most aligned with Darwin’s notion of survival of the fittest, that is, the ability to adapt. (Darwin asserted that it was not the strongest or fastest that survived but the most adaptive.) In this sense, we have been able to provide accurate assessments of the prognosis for a Red X based on this critical factor. The good news is that many Red X’s (about half) are open to feedback and change.

Our intention here is to help them adapt by leveraging their strengths (those things that they are most comfortable doing) and minimizing their weaknesses (usually the things that make them a Red X). Sounds simple, but keep in mind that the Red X has been this way for a long time and that “Rome wasn’t built in a day,” so change will be a slow and deliberate process. Leaders need to have patience and be realistic. A skillful coach who works with both the Red X and the immediate team can modify behaviors enough to largely reduce the toxic effects. Concerning change: a little goes a long way:

**IN THE INVESTMENT INDUSTRY OUR MANTRA IS: “HIRE SLOW AND FIRE FAST.”** Getting it right from the start saves money, time and irritation. Therefore it’s important for leaders to leverage the notion of “learning agility” (as we call it, “curiosity”) in the hiring process. During the process, interviewers can be trained to assess a candidate’s level of curiosity. Because this factor is the single most important element in managing a Red X, it can be the deciding factor in a good vs. bad hire. Red X’s who practice curiosity can learn to function within a culture in a healthy way. This provides the best shot at a win/win outcome: unique skills plus cultural fit.

Investment leaders need to understand the Red X phenomenon because it is central to active management. The creative tension that Red X’s bring to an organization is the price paid for superior returns. Alpha seeking organizations should embrace the
quirky nature of fund managers who can see around corners. But often they don’t. Jennifer Mueller, a Wharton professor states, “It is almost impossible to get people to say they don’t want creativity. But when someone actually voices a creative idea, there is a response of, ‘Wow -- What is that?’ This issue really comes to life at the moment the idea is voiced. There is discomfort when people encounter creativity.”

**WE HAVE WITNESSED THIS PHENOMENON MANY TIMES.**

True creativity — in the investment world: real contrarian thinking — usually encounters resistance. And yet investment leaders the world over will acknowledge that independent, contrarian thinking is exactly what is needed to win in the markets. In his book, *Future Edge* author Joel Barker looks at true breakthrough thinking and shares the message that paradigm shifts often come from the fringe. Barker continues to say that these ideas are usually overlooked by the conforming masses. The Red X lives on the fringe. In this sense, investment leaders must live with the love/hate relationship they have to Red X’s. They love the contrarian, creative thinking and they (often) hate the friction it creates within the firm. For this reason, many investment firms embrace the core value of challenging ideas, that is, playing devil’s advocate on a regular basis. The very successful hedge fund, Bridgewater, has made a core value of debate. Ray Dalio says, “I believe that our culture must have very open, honest and logical people debating with each other in pursuit of excellence and recognizing their mistakes and weaknesses in order to achieve rapid improvement.”

**Firms that manage the Red X’s well have created a culture of cognitive diversity, in which there is genuine appreciation for different points of view and creative expression. In some respects a successful investment firm is like an ad agency in which the “creatives” and the “suits” are recognized for their talents and placed on separate floors. Creative types are allowed to have long hair, casual dress, lava lamps, and quirky offices. Suits are the face of the firm to the clients and look the part.**

So, when does the Red X issue become serious? When should a CEO or CIO pay attention? The answer: when talent is at stake. If the behavior of a Red X is threatening to drive talent out of the organization, then leaders must take action. The fact that your talent is leaving is no different from dumping bushels of money out of your office window. The worst case we know of is a CIO who drove out three talented investors who set up a competing firm across the street. Ouch.

Some Red X’s suffer from narcissistic personality disorders (i.e. giant egos) and can’t imagine that the loss of one or two “ordinary” types is of any concern. They suffer from huge biases around “attribution.” That is, they believe that they are responsible for all the good things happening in a firm, and the others are “oxygen thieves” (as one Red X put it). An article entitled, *The Risky Business of Hiring Stars*, makes clear the perils of this viewpoint. In particular, the article states that only 30% of performance comes from the star fund manager, whereas the remainder is the support team. This is why star managers who move from one firm to another struggle to replicate their success. Who knows if these numbers are exactly right, but the point remains: no fund manager creates the success in a vacuum. They all have support staff feeding them ideas, providing data, building spreadsheets, executing trades, etc.

Ultimately, we see the Red X as fundamental to the active management process. In most cases the Red X is not a problem to be solved, but a paradox to be managed. Investment firms should not set a goal of “eliminating Red X’s,” rather the goal is to manage them so that their creative powers are harnessed for the good of the client. And, as with a nuclear reactor, contain the radioactive waste so that no one is harmed. When this balance is found, it is a win/win for all parties: the clients, the employees, and the owners. ■
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JIM WARE is the founder of Focus Consulting Group, a firm that helps financial leaders understand and leverage their firm’s human capital for competitive advantage.

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His books have been reviewed in The Wall Street Journal, and he has presented at over 100 CFA events in 18 countries. His background includes a Masters in Business from University of Chicago.