Good Judgement

By David Winsborough

Five years ago this month Brendon McCullum gave up keeping wicket for New Zealand, even though it may have cost him his place in the team. His rationale was that he would become a top batsman and prolong his international career. That call that paid off spectacularly, for him and his country. He ranks 15th in world test batting, 27th in ODIs and 5th in 2020 batsmen. More significantly, as NZ captain McCullum encouraged the team to adopt the same aggressive, risk-taking style he has. Seemingly unafraid of losing and uninterested in draws he is now NZ's most successful cricket captain.

Leadership theories commonly focus on individual characteristics like intellect, charisma and power, but the key drivers of leadership performance are the leader's decisions. Positive organisational outcomes are the consequence of good leadership decisions; negative organisational outcomes are the product of poor decisions.

The proxy measure for judgement has tended to be IQ. The theory goes that if you have the smartest people around, then success is simply a matter of time.

This is especially so in the world of finance, where physics PhD's mingle for lunch with statistics geniuses and Nobel Prize winners. Sadly, having the smartest guys in the room didn't help Long Term Capital Management, who employed 2 Nobel winners (Myron Scholes and Robert Merton, who shared the 1997 Nobel Prize in Economics for a method to value derivatives). Initially successful, LTCM lost $4.6 billion in less than four months following the 1997 Asian financial meltdown and 1998 Russian financial crisis. The Federal Reserve paid the bill, and LTCM was wound up in 2000.

In contrast to LTCM, consider the NZ Superannuation fund, which is the best performing sovereign wealth fund over the past five years, generating returns of more than 17 per cent a year. In the last three years alone, the fund returned an average of 21 per cent a year. Describing it's performance NZ Superannuation's CEO, Adrian Orr, said that the fund "leaned in" when they thought markets were cheaper, buying shares in the depth of the GFC when all other funds were liquidating equities.

Orr is globally feted for the clarity of his thinking. Before his arrival NZ Super left key decisions about active investment strategies to external managers. Orr reversed that decision, redeemed capital and owned many of the risks to which the fund was exposed. Critically, Orr published his beliefs (alongside known facts) as the founding basis for investment decisions.

Investment Decisions	Investment Beliefs	Investment Facts
Governance and investment objectives	Clear governance and decision-making structures that promote decisiveness, efficiency and accountability are effective and add value to the Fund.	It is important to be clear about investment objectives for the Fund, risk tolerance, and the timeframe over which results are measured.
Asset allocation	Asset allocation is the key investment decision. Investors with a long-term horizon can outperform more short-term focused investors over the long-run.	Risk and return are strongly related. There are varied investment risks that carry premiums / compensations. Illiquidity risk is one such premium. Investment diversification improves the risk to return (Sharpe) ratio of the Fund.
Asset class strategy and portfolio structure	Asset class expected returns are partly predictable and returns can revert toward a mean over time.	Investment markets are competitive and dynamic, with active returns very difficult to find and constantly changing source. Market volatility tends to cluster over short horizons but mean-reverts over longer horizons. Investment risks can be unbundled to make the Fund more efficient.

Leaders mostly make decisions about strategy, staffing and capital investments. Thus, good judgment is an essential component of effective leadership at both macro and micro levels.

Orr's leadership style— and unruly sense of humor— are behind his ability to lure talent to NZ.

"If you look at the experience profiles across the fund, we don't have the asset manager with 20-plus years in a given discipline.

Twenty-plus years in real estate may be a badge of honor, but that doesn't tell me whether he or she can sell and buy" Instead Orr places a premium on intellectual flexibility and diversity, taking staff from a wide range of backgrounds – not just finance.

Raw intellect is not enough. The personalities of individuals are critical to understanding the dynamics, consequences and reactions to decisions. How a leader makes decisions, and in particular, whether they are capable of displaying good judgment, is critical to organizational effectiveness.

As Orr and McCullum show, judgements are always risky, but by being self aware and knowing one's own preferences and biases can be the basis of spectacular success.

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