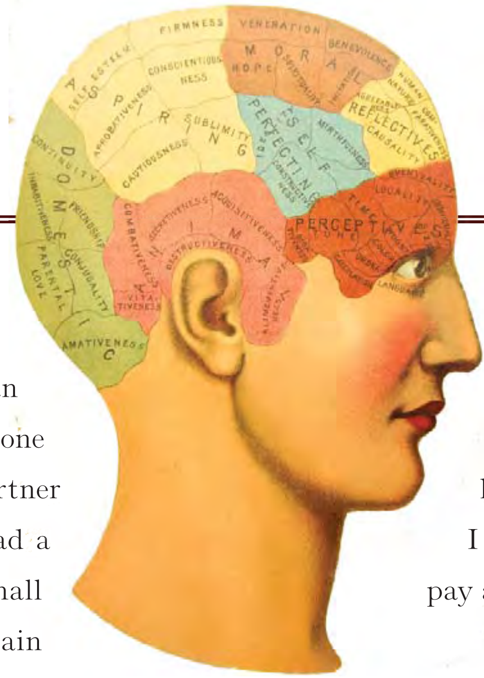
The Brain

Jack Davidson

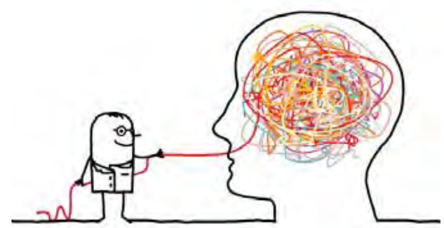


As an adolescent, I found the "brain" uninteresting. I used mine sporadically. It was simply an instrument to help me go from one place to another. It wasn't a partner in decision making. Early on I had a simple goal. I wanted to live in a small town and raise a family. The brain helped me.

I found a job. To keep the job, I needed skills. I learned the skills. My line of business encompassed fiduciary law and investment management, which were like commodities focused on the brain. I would have preferred to be Steve McQueen, but I could not quite figure out how to become Steve McQueen while maintaining my identity as a Trust Officer at the Vermont National Bank . [1]

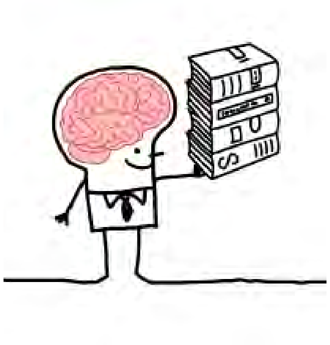
As the years passed, I started to view my brain as a partner. Certainly I needed it to maintain my skills, but I also found it be a pleasant companion. It was no longer just an instrument. It was a friend who sometimes suggested "Why don't you just explore without purpose?" Now to be fair, my brain is manipulative. It periodically reminds me that if I don't maintain my skills, I will have to retire and just play golf. Oddly, I find that threatening so I continue to pay attention to our relationship.

At the end of December, my friend almost left me. I had a head-to-head encounter: mine and a head of lettuce. The lettuce won. I collapsed in the produce section at Price Chopper and was unable to have a dialogue with the head of lettuce opposite me as I pondered its features and my inability to at least find someone else to talk to. Fortunately, the Price Chopper was 500 yards from the hospital, and my good fortune of proximity resulted in a dramatic reversal of the effects of a stroke.



After a short hospital stay, I was advised to spend two weeks at home with very limited mental activity. I strayed. My friend and I could not sit in a room for two weeks and not talk. So we did. I pondered not just about my brain but the brains that I work with.

In our business, we rely on "Brains - ours and others - that we call upon to help us invest long-term. "Brains" can be expensive. Often people choose investment managers based on academic credentials and proximity to financial centers. Harvard MBA's tend to be expensive and reluctant to relocate in "sleepy" Vermont towns. The marketing value could be priceless were we to entice one or more to our inventory of managers.

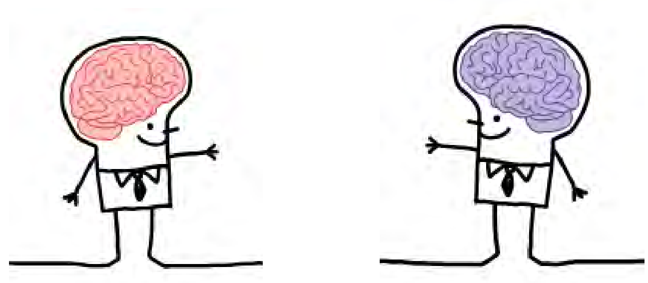


Alas, hedge fund management has accelerated the marketing of the "Brain." There is a widely held belief in the asset-management industry that the hedge-fund industry attracts the "best and brightest." This business adds a dimension not found often in traditional investment management. Traditional Managers look for good stocks. Hedge Fund Managers tend to move in a riskier investment world. They look for good stocks....... and bad stocks, and they leverage the latter.

Over time, we see institutional money grow locally and then move out of state in search of the "best and the brightest." As a result, some institutions have modified their services to embrace "Manager of Managers" programs. This strategy can be both cost effective and, perhaps, effective in managing assets. A local manager selects other managers, usually by way of mutual funds, thus allowing access to "the best and brightest" while still maintaining contact with an in-state provider of management oversight.

I might add that our company embraces the "local movement." We were locally grown, we are locally owned, and, although the data is still debatable, we are not genetically modified. We do not embrace the "Manager of Managers" concept and all of our managers live locally.

How effective in management of assets is the "Brain?" In 1994, Salomon Brothers bond trader John Meriwether launched Long Term Capital Management and brought on board Nobel Prize-winning economists Myron Scholes and Robert Merton. At the time, many in the investment community were in awe of the prowess of this group. However, their spectacular demise in 1998 also stunned the community. Despite the collective acumen of this enviable group, it was unable to foresee the impact of the Russian financial crisis.[2]



At the time, I recall a wise observation that still resonates - the best managers have a "knowing" of when trends change which can be independent of academic pedigree. At the time I assumed this individual was talking about the left and right brain in investment management.

The Investment Community seems to have co-opted the definition of right and left brain. The community defines the right-brain investors as emotionally impulsive and left-brain managers as cloaked with the wisdom of those who carefully weigh the costs and benefits of a particular investment.

My definition of "knowing" is the "adaptive unconscious," which I first encountered in Malcom

Gladwell's book, "*Blink.*" Gladwell writes, "When we talk about analytic versus intuitive decision making, neither is good or bad. What is bad is if you use either of them in an inappropriate circumstance."

Often I see right- and left-brain conflicts. If you are a lawyer, you take pride in your left brain. If you are an artist, you wear the right brain badge of honor. The concept of the "adaptive unconscious" may simply be an effective way of saying that the whole brain wins, not just one of its parts.

How effective is "Brain" power in effective investment management? Certainly those who designed the algorithms and tranches evident in the subprime funds made famous in 2008 were highly creative but, on the whole, the investment community suffered profoundly and the damage is not yet complete.

How do we find "knowing" people? It is a challenge.

But I know what I and my colleagues want to avoid. We avoided the subprime funds of 2008-2009 simply because we refused to buy something we did not understand. As a result of the current low interest rates, we see an increase of late in "murky" investments that remind us of funds that fueled the last market before the crash. We plan on staying the course. It is not easy; we are certainly aware that safe, fixed-income securities yield appallingly low rates.

I recently met a women who worked for an international non-profit based in Connecticut. Her organization had a strict philosophy of avoiding risk. The organization's policy did not allow for investing in stocks; "A" rated Bonds and bond funds were permitted. Relying on Moody's, the portfolio declined by 40% at the end of 2008 as a result of holding A-rated sub-prime funds.

In our company, fixed income securities stabilize the value of portfolios. They need to be safe. Now the siren call to increase yield is suspect. This world is growing more unsafe. Are these new funds, designed to attract the risk-adverse investor, the product of creative brains who work for us - or are they working against us?

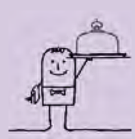
So at the Trust Company we need to be agile. We need to understand the market. We also need to understand our clients and their needs. This is our responsibility.

When I returned to work after my two week period of rehabilitation, alone with my brain, I may have emerged as an "enlightened" man.

I now know how to adjust my brain power and exert positive efforts to increase my brain's effectiveness. Monitoring IQ can be important.

Quoting our esteemed Warren Buffett: "You don't need to be a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."

I have learned to adjust my IQ and I created a scale to assist me:

Trait or Activity		Effect
Arrogance		- 10
Impulsivity		- 20
Ability to Listen		+ 20
Running late		- 10
Fear		- 20
Cognitive Dissonance		- 20
Cup of Coffee (per cup)		+ 5
Focusing on client needs		+ 20

I suspect that I need to nurture the minuses so I can get into the 130 range. Some of my colleagues, on the other hand, have suggested that I should focus on the pluses.

My Mother had a "Third Eye"[3] Facts, logic - none of it mattered. She just seemed to come to the right conclusions. Were she here today she would probably say "If it's too good to be true, it's not true."

In this current environment, we need to repeat this advice more then ever. The infamous Bernie Madoff was well aware of this immutable truth. He manipulated his stated yield so it stayed just below the radar of "too good to be true."

If a company's interest is congruent with the clients' interest, the "Brains" stand a much better chance of realizing the clients' goals. Otherwise, the outcome is unpredictable and perhaps dismal. This is what I know.

"Look closely, Ms. Fleere—do you see the man who managed your hedge fund?"

1. Even after buying a motorcycle.

2. The Nobel Foundation just announced that it was reducing the cash awarded with Nobel Prizes by about 20 percent. The reduction was the result of poor returns on its invested capital, which was valued at $419 million as of Dec. 31, down 8 percent from the previous year.