We interviewed the investment team of the MIT Investment Management Company, based in Cambridge, Massachusetts for *The Manual of Ideas*, the flagship publication of MOI Global, in 2014.

We had the privilege of getting a glimpse into the decision-making process at one of the world's finest allocators of capital, the MITIMCo. In this exclusive Q&A, President Seth Alexander and global investment team members Joel Cohen and Nate Chesley share their process for identifying and partnering with exceptional investment managers. The team also provides invaluable lessons to emerging managers who aspire to become the superinvestors of tomorrow.

In their mission to deliver outstanding long-term investment returns for MIT, Seth, Joel, Nate and the rest of the MITIMCo team seek to cultivate an ecosystem of enduring partnerships with no investment manager being "too small, too young, or too 'non-institutional'."

The MITIMCo team's perspective and advice are timeless and truly invaluable for emerging managers looking to build a great investment firm. Enjoy!

MOI Global: How did you get interested in investing?

Nate Chesley: I didn't grow up with a lot of exposure to the stock market but was always inclined to view the world through an economic lens. I studied finance and economics in college where I came to appreciate the role of the capital markets as a sort of circulatory system for the global economy. My early professional experience at an investment consultancy was influential in my desire to invest for the benefit of an extraordinary institution like MIT, where the capital we manage is reinvested in world-class scholarship, research, and global problem-solving.

Seth Alexander: I took a course on endowment management taught by David Swensen and later went to work for him. He is both a wonderful investor and a wonderful teacher so it was a very fortunate experience. I think I was initially drawn in by the quality of the people at the Yale office and later by the breadth of the business.

Joel Cohen: Similarly, my interest in MITIMCo came first and my passion for investing came after I started working here. In my job search during my senior year of college, no one else came close to what MITIMCo could offer in combining interesting and challenging work, a real commitment to investing in every member of its staff no matter how young, and an incredible mission.

Within a few months after I joined MIT as a 22 year old, I realized that investing was actually an even better fit for my interests and personality than I thought. I've always been intellectually curious and enjoyed reading widely – I was a philosophy major in college in addition to econ, after all. So when we read Hagstrom's *Investing: The Last Liberal Art*, it clicked for me why I found it fascinating: investing is an ongoing quest to integrate mental models from a variety of disciplines into a framework for understanding the world and making decisions. I feel very lucky to have joined an organization that thinks about investing that way.

MOI: Which people and/or experiences have shaped your investment thinking?

Seth Alexander: It is honestly a little hard to pinpoint the exact source of what has influenced our thinking most. We gather thoughts and ideas from lots of different places and try to amalgamate them into what makes sense for us. Probably our best source of investment thinking comes from conversations with managers in our portfolio. There are lots of challenges they face – how to build an organization, how to size positions, how to structure a typical day, when to hold cash, and so on – that are analogous to challenges we face and so we have been influenced a lot through those discussions.

For example, we restructured the organization a few years ago to make everyone generalists based on what had worked well with some of our managers. We also read a great deal. We have an internal book club that covers science and history and other subjects to help us generate ideas from outside the investment world. We are very happy to borrow ideas so we do that liberally and work to fit them into our frameworks.

MOI: How have you gone about building the organization and team?

Seth Alexander: We have tried to find the best athletes with a passion for investing, not necessarily the most experienced investors. We also look for people who get excited about the ways MIT contributes to cancer research and alternative energy research and other efforts. We started early on with a vague organizational chart and eventually eliminated it altogether to make it clear we wanted people with all levels of experience to come in and contribute as investors and partners.

We do not try and hire someone every year or anything like that. Instead, we hire opportunistically. If two great people came along in the same week who would both be a great fit, we would hire them. We are always looking to hear from passionate investors about working here and really encourage people to reach out to us.

MOI: What is similar/different in the skillset required to successfully invest in securities versus investing in managers?

Nate Chesley: We avoid drawing too bright a line between our approach and direct investing because there are more similarities than differences. We have a culture and mindset of thinking like owners and focusing on the micro that is motivated by Graham’s sentiment that “investing is most intelligent when it is most businesslike.” That leads us to focus a lot of our time understanding how our capital is invested bottom-up in the specific companies, properties, and other securities we own through our managers.

One similarity between the two skillsets is the emphasis on evaluating people. Our approach to underwriting investment managers is quite similar to the way a stock-picker might analyze a company’s management: an intense focus on integrity, a track record of outstanding judgment, and a clear alignment of interests. Also, for every investment decision we make we evaluate the margin of safety, the range of potential outcomes, and the associated probabilities – just as one would do when investing directly in a security.

One difference might be our generalist approach. Each member of our investment team has the flexibility to cover the entire waterfront, whereas many investors are intensely focused on a very specific niche, such as biotechnology stocks or early stage consumer technology companies – or at least one particular asset class or geography.

The Process of Identifying and Partnering with an Investment Manager

MOI: You have stated that you “aim to establish investment management relationships that last decades.” What are the key implications of such a mindset on how you go about doing business and what managers you look for?

Joel Cohen: MIT, which hopefully will continue to be a leader in education and research hundreds of years from now, is one of few market participants for whom even decades are a comparatively short time period. We think this creates an enduring competitive advantage in a market where three years passes for long term. Thinking about partnering with managers for decades naturally leads us to ask a lot of questions to understand the trajectory they are on and what they are trying to accomplish. For example – how do you define success? How are you building an organization around that goal? Which investors do you hope to emulate? What are you doing to become an even better investor 10 years from now than you are today?

Another implication of this multi-decade mindset is we have a willingness to engage with managers earlier in their careers. These managers can have decades of compounding ahead of them. Will the 25 year old manager we just hired still be compounding our capital half a century from now? We are excited that it is even a possibility!

MOI: How do you categorize investment managers?

Seth Alexander: The biggest way we categorize managers is whether or not they fit into our comfort zone. For example, in looking at public markets investors we have defined our comfort zone as long-term oriented, fundamentals-based, value investors that pursue strategies we can understand and underwrite. This narrows the field quite a bit, as macro, quant, momentum/trading, and benchmark-driven strategies tend to fall out.

Beyond that, we actually try pretty hard not to categorize managers. We tried for a while but every time we came up with a classification scheme, we would come across an interesting manager that did not fit. The more we thought about it, the more we realized that perhaps exceptional investors by definition could not be easily classified. Once we got comfortable without having classifications and just focused on finding great investors, we were much happier.

MOI: What is your process for evaluating managers to find the ideal manager? Does that process differ depending on the type of manager, and if so, how?

Nate Chesley: Our process deemphasizes asset class distinctions in favor of a manager-centric approach, so our process is generally consistent across all types of strategies. However, we have accumulated a variety of mental models for different strategies that provides a framework through which we hone-in on the key risks and areas of potential exceptionality across investment strategies. This manifests in a sort of internal lexicon that allows the team to evaluate a wide range of opportunities with the same process, but more nuanced understanding. For example, we've developed an appreciation for equity strategies that are unusually long-term in nature. It occurs to us that there are huge inefficiencies when you to try understand what a business could look like five or ten years from now. This is not easy, but we've studied investors who have pursued this approach and have developed our own understanding of the attributes a manager might have to succeed with this style of investing. Jeff Bezos talks about this, saying that on a three-year time horizon, you're competing against a whole lot of people. But if you're willing to really lengthen your time frame, there is a fraction of the competition because so few people are willing to do that.

We focus on evaluating opportunities that are within our circle of competence, which is bounded by our core investment principles. The nature of our research really boils down to: developing conviction in the quality of an investor's judgment; understanding the risks to which our capital is exposed; and ensuring that the right structure and alignments exist to serve as the foundation for a long-term partnership. On a practical level, we spend our time conducting in-person meetings; reading any relevant materials, such as letters, investment case studies, or company materials; conducting reference calls; and analyzing historical data.

MOI: You have stated on your website that "since exceptional judgment is crucial to virtually all investment strategies, a critical element of our due diligence process is to evaluate historical decision points." What are some examples of such decision points and how do you go about evaluating them?

Joel Cohen: I'll give an example from a manager we recently underwrote. In the mid-2000s, he stumbled across a small, sleepy community bank that had earned high ROAs and ROEs for decades. He thought to himself, how on earth do they do that? As he explored further, he discovered that there were quite a few others as well, and eventually it became clear that these were gems of businesses if they had certain characteristics. Of course, banks at the time were very overvalued because it was a boom time for the financial industry. Nonetheless, he knew the industry was prone to the occasional crisis so he did his work and identified a handful he would love to own – at one-third the valuation, of course. Four years later the financial crisis hit, and these great banks were babies thrown out with the bathwater, so he got the chance to participate in their high rates of internal compounding at discounts to book.

Now, what does this tell us about the manager's judgment? First, he correctly identified these banks as quality assets. Second, he had the discipline and patience to wait four years before touching them. Third, he had the stomach to buy them in the midst of a financial and economic panic. These things are all as unusual as they are impressive.

MOI: How do you define a manager’s investment record and how important is it in your overall due diligence? What do you look for in a track record?

Joel Cohen: Over time, we have learned that great investors tend to be more focused on process than on outcomes. So, we try to follow this principle as well. The idea goes that if the process is correct, results will take care of themselves over the long term. Of course, a track record, if presented over a long period of time, is an important check on whether what should work is working. But we have to be cautious about this, as even great managers have multi-year periods of meaningful underperformance – there is a great Eugene Shahan article from 1985 about how plenty of investors with great long-term track records looked mediocre in any given year and underperformed for three or more years in a row in many cases. If our own investment process works well we should be able to identify great investors even when their backward looking track records temporarily look mediocre – and I think developing conviction in their processes is the way to do that. A number of years ago, we hired a health care focused manager who had earned essentially market-like returns over the prior seven years, but we understood the reasons for their performance and had enormous conviction in their process and judgment. Subsequent returns have more than justified our decision.

MOI: How do you make decisions throughout the stages of the process? What are some instances that make decision-making especially difficult/easy?

Seth Alexander: For every new investment opportunity, we form underwriting teams of two to four people. They work together to establish a due diligence plan with appropriate checkpoints to keep the rest of the team informed. If we want to proceed forward on something, we put our thoughts on paper into an investment memo that describes the investment manager, our reason for investing, our concerns, our sizing calculus, our due diligence, and anything else that might be relevant. This is important because we want to have a very transparent process that provides plenty of opportunities for the rest of the team to give feedback, ask questions, and debate points of disagreement. Ultimately though, it is the underwriting team alone that makes the final decision to make sure we avoid group-think. I meet every manager, usually near the end of process, and technically can veto the underwriting team’s selections but that does not happen very often. The underwriting teams have imposed a pretty rigorous process on themselves to ensure that the things that make it through our process are compelling.

Honestly, we do not seem to have a lot of easy decisions. That may be because there are shades of grey in every decision for us to argue about. Even if we don’t argue about the soundness of the decision itself, we can still argue about the sizing of the decision or what red flags to watch out for or the appropriateness of the fee structure. The other thing that adds complexity is that we tend to focus on managers earlier in their careers so there is less evidence to examine and we are always going to have to make a judgment call on the future potential of the people involved. For example, of the last twelve managers we’ve hired, eight founded their firm in the last two years.

MOI: What are the attributes of exceptional managers/firms?

Joel Cohen: We try to be humble about thinking that we can crack the code of what makes a firm exceptional, even though we will spend our whole working lives trying to do it. We have developed our own, constantly evolving, always imperfect view of what constitutes an exceptional investor based on many years of working at it. If you define an exceptional firm as one which achieves outstanding returns over a very long period of time, one trait they all seem to have is that they view investing less as a job and more as a vocation or a form of self-expression. There are a lot of nice side effects that you often see from people who come to investing this way. First, they tend not to take a cookie cutter approach to investing or try to cater to what they think allocators want, but instead spend more time tailoring their methods to their own personality and what works for them. For example, with the manager I mentioned earlier who studied small community banks, he realized that the intellectual engagement of identifying great assets regardless of price, adding them to his list of things to follow, and then waiting for a crisis felt natural to him, and leveraged the skills he has that are most uncommon. Second, if investing is someone's passion, they are going to be thinking about it in the shower, on the subway to work, etc.. Most importantly, their efforts are going to be sustainable. Time spent working is not a sacrifice, but an indulgence. Those who pursue investing for intrinsic reasons seem to keep performing at a high level for long after those who were in it for the money.

MOI: Seth Klarman is quoted as saying, "Value investing is simple to understand, but difficult to implement. The hard part is discipline, patience, and judgment." How do you define these elusive traits—discipline, patience, and judgment—and how do you recognize them in a manager?

Joel Cohen: These traits are hard to define, and if you asked different people on the team I'm sure you'd get different answers. To me, discipline means a willingness to keep one's standards incredibly high across an organization – in hiring people, making investments, and making business decisions. Patience is a willingness to forgo activity today in order to end up with better results over the long term. Judgment is the ability to conquer the behavioral side of investing, think clearly in terms of probabilities, identify the key variables, and weigh difficult tradeoffs.

Given the amount of time we spent with managers analyzing their historical decisions and talking about companies, there is generally a good body of qualitative evidence to make a reasonable judgment along these lines. One thing to look for is whether the manager has worked to create an environment, structure, and set of routines that enable them to be patient, disciplined, and to exercise good judgment. The great investors seem to design their whole operation with these things in mind – from the people that they partner with, to the way they spend their time, to the things they focus on in their letters, to the way they set the organization's culture and habits.

MOI: You have talked about the need to "identify and underwrite the competitive advantages that allow sustained outperformance" of a manager. What are some examples of such advantages?

Nate Chesley: Bill Miller's categorization of competitive advantage is a sound framework. He offers three with which you are most likely familiar: informational, analytical, and behavioral. I might add to that list "structural", which serves to reinforce an investor's ability to leverage their behavioral advantage. For example, access to stable capital is a huge tailwind to an investor's ability to be patient and disciplined. I'd also note that competitive advantage may be derived from the accumulation of many small advantages thoughtfully linked together and executed well. This is in contrast to what you might find with an exceptional company that operates with one big competitive advantage – for example, a cable operator that benefits from a regional monopoly resulting from the local ownership of privileged physical assets. Larry Pidgeon of CBM Partners is an example of an investor we really admire whose competitive advantage came from a long string of small advantages. Before starting his partnership Larry worked with Lou Simpson at GEICO. He was someone whose many years of experience had given him a deep reservoir of accumulated knowledge and wisdom about businesses, which complemented his even temperament, thoughtful and methodical nature, and instinct to behave in a highly principal-oriented way, as if all the capital in the fund were his own. None of these may seem so unusual in isolation, but together they create a powerful advantage.

MOI: Do you prefer generalists or specialists among your managers?

Seth Alexander: It really depends. We try to think carefully about where the competitive advantage might be. Sometimes the generalist has the competitive advantages and sometimes the specialist has the advantage. If I think about the biotechnology sector, I am pretty sure I want to work with a specialist because the industry is complicated enough that focused expertise and analysis can be of real benefit. For a distressed debt manager, on the other hand, we would typically favor the generalist because this opportunity set is created by distress and fear that could arise in any industry anywhere in the world and there would be a benefit to being able to allocate across a very wide universe.

MOI: How do you approach your manager relationships?

Joel Cohen: Once invested, our primary objectives are continued learning, relationship building, and trying to help our managers achieve their goals. On the first point, while we aim to do most of our work upfront, we tend to find that great investors evolve in interesting ways and so we continue to learn a lot – both from them and about them – after we invest. A lot of this is work we can do on our own – for example, by learning about companies they own, or by reading the books the manager recommends to us. In terms of relationship building, we are working to build the kind of trust and open dialogue that can help the partnership withstand difficult times. The emphasis on helping our managers achieve their goals in any way we can is another implication of our multi-decade partnership mentality, because we believe that working really hard to be great partners can expand our managers' moats and make a difference to their long-term performance in a modest but meaningful way. This can be anything from using the MIT network to help a manager solve a problem to structuring our interactions differently in order to minimize disruptions to their productivity or thought process. Usually of course the best way we can add value is if we just get out of the way and let a manager do their thing, and we're happy to do that too.

MOI: How do you decide when to part ways with a manager?

Nate Chesley: This is a very difficult part of our process, but an important one if we are to fulfill our duty of producing truly exceptional returns for MIT over the long run. Our ideal outcome is to partner with a manager for decades, but this isn't always the case. First, we make mistakes. We have to be brutally intellectually honest with ourselves in recognizing our mistakes and seeking to learn from them. We have an internal culture of transparency and open debate in which the entire team has exposure to all managers across the portfolio and can identify where we may have weaknesses so we can have an open debate about them and take action if need be. Firms also can evolve. Our ongoing relationship and monitoring efforts evaluate an investment's evolution relative to the expectations we established during our initial underwriting. Competitive advantages can erode, key people can depart, small stresses can develop into considerable issues, and incentives can change. We are mindful of these shifts and must create sufficient pressure on ourselves such that we are always raising the bar of exceptionality within the portfolio. In a recent example we parted ways with a manager because AUM had more than tripled since we invested, and we felt their competitive advantage depended on being small and nimble.

Advice to Emerging Managers

MOI: What is the best preparation a manager can have before starting to manage other people's money?

Seth Alexander: One perhaps obvious thing that we have noticed is that it is helpful for people to have a good mentor. Good mentors are thoughtful people who are motivated by a desire to help you grow and succeed, and generally don't have a vested interest beyond that. This makes them likely to give honest feedback and invest time in helping you.

Some people start naturally with a mentor because that is how they were introduced to the business but others have to proactively search them out. From our vantage point it seems like the people who have spent the time to find a good mentor have found the effort involved to be very worthwhile. In some cases, we have been able to provide introductions of experienced investors to younger managers to help create a relationship.

MOI: What are some common mistakes you see emerging managers make?

Nate Chesley: The most common mistake we see is when an investor makes small compromises in the early days of the partnership in ways that limit future success. These seemingly small compromises at the outset compound over time into considerable stresses, which are prone to fracturing at the least opportune times. People compromise on the quality of their LP base, unwilling to turn away the wrong investor. Start-up managers sometimes have the misguided view that they need to be all things to all potential sources of capital and compromise by adjusting their strategies to investor demands. We also see investors give away economics in their business in seed deals in order to scale-up as quickly as possible. We've observed that almost all the very successful and established firms we work with turn away large amounts of capital – they even did so when they were small, by the way – because they understand the need to apply the same high bar to their choice of partners as they do their choice of investments.

MOI: What is the biggest misconception emerging managers have in terms of attracting institutional capital, including from MITIMCo?

Nate Chesley: One thing that many people remark on when they meet us the first time is that we are very different from their conception of what a traditional institutional investor would be. They are surprised to hear we spend a lot of time meeting with managers in their 20s and 30s, that we are frequently the first or only institutional investor in a firm, that a meaningful number of our firms are one- and two-person shops, and that we are very content with unconventional firms and strategies. We have made a deliberate effort to invest in un-institutional firms because many investors with exceptional long-term track records have been unconventional and un-institutional. So I think there is an interesting misconception here that all institutional capital thinks the same way.

MOI: What advice do you have in terms of structuring the fund?

Nate Chesley: First, there is no one-size-fits-all solution. There are many aspects of a partnership's terms and conditions that should be thoughtfully tailored to the strategy's objectives. The foundation starts with a long-term vision of success that is shared by both the manager and the investors. We think a lot about alignment of interests over the life of the partnership and want terms that serve that purpose. Ultimately, we're really aiming to create structures where managers are rewarded for producing exceptional results for their partners. Our intent is not fee minimization – we want to create incentives for the manager to attract and retain talent and to do extraordinarily well if they produce outstanding returns.

A while ago we came across a group of stockpickers with one of the best structures we've seen in terms of aligning the whole operation around the compounding of capital. First, the management fee was budget based rather than a percentage of assets, which removes the strong incentive to grow AUM. Second, the performance fee was tied directly to long-term performance (in this case, 5 years) over a 6% hard hurdle, and a significant portion of the performance fee was held in a reserve against future poor performance. This removes the temptation for the either the manager or their LPs to focus on annual results. So, the structure was very well aligned, which served the manager just as well as it did their investors – it helped them attract a group of very high quality partners, generate one of the best records we have seen out there, and create significant personal wealth too.

MOI: Managers who are just starting out often take the view that as long as they take care of the investment side (i.e. achieve a good 3 or 5-year track record), the business side of the firm will take care of itself (i.e. allocators will come knocking). What's your view?

Joel Cohen: Broadly, I think we subscribe to the view that if you have a compelling value proposition, it is hard to imagine you will not attract attention over time. I would not agree though with the idea that the business side does not deserve attention in the early years.

First, it can take a lot of work to figure out how to set up a fund with a cost structure that doesn’t force you to go out and raise a lot of early capital from the wrong partners. Second, just because you are not spending time on marketing does not mean you should not be investing in building your business, for example by creating a roadmap for building your firm and in creating the materials you can use to communicate to prospective investors later on. Even something as simple as an “owners’ manual”—like Buffett did for Berkshire Hathaway—can help clarify your thinking for yourself and share your thinking with prospective partners when they arrive.

MOI: What are some resources you would recommend to emerging managers?

Joel Cohen: There are a lot of great books out there whose insights can be helpful to the up and coming investment manager. Charles Ellis has a paper called “Characteristics of Successful Investment Firms” that is great food for thought. There is also the Eugene Shahan article we mentioned earlier that is worth sharing with all of your partners to make it clear that short-term underperformance is not inconsistent with meeting your long-term goals. *Built to Last* is an enjoyable read with plenty of insights for anyone building an organization—consider pairing it with *The Halo Effect* for another point of view.

In terms of generally good reads, I’d recommend *The Art of Learning* by Josh Waitzkin, *Different* by Youngme Moon and some well written business histories like *Built from Scratch*, *Made in America*, and *Nuts!* I imagine most people have read Daniel Kahneman’s *Thinking Fast and Slow* but I mention it because it is so good and because it is a great book to be reading as you are designing decision making processes.

MOI: If there is one thing an emerging manager should ask himself or do after reading this interview what should that be?

Seth Alexander: We would recommend that a new manager write down on a piece of paper what their definition of success is and then systematically go through everything they can control—their business structure, who they let in their fund, how they spend their time, what fees they charge, and so on—and make sure that everything is aligned to reaching that goal.

Of course, the other thing that an emerging manager should do after reading this is give us a call! We are always looking for good investors to partner with. If something resonated in this interview, we can be reached at www.mitimco.org [or via MOI Global].

MOI: Thank you very much for your insights.