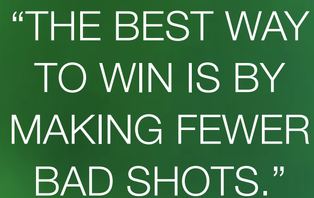

Avoid Losing the Investment Game

Dr. Simon Ramo of TRW, Inc. (now a part of Northrop Grumman) identified the difference between a winner's game and a loser's game in his book, *Extraordinary Tennis for the Ordinary Tennis Player* (pub. 1977). Dr. Ramo summed it up this way: professionals win points; amateurs lose points. The extraordinary tennis players rarely make mistakes, called "unforced errors." When a superior tennis player is competing against an average opponent, the superior player wins—but not due primarily to making winning shots. Rather, the average player loses by committing unforced errors; that is, hitting the ball into the net or out of bounds, or committing a double fault on the serve. In amateur tennis, the final outcome is determined by the activities of the loser, who defeats her/himself.

The same is true in golf. Former professional golfer Tommy Armour said, "The best way to win is by making fewer bad shots." You don't have to make great shots, just avoid making terrible shots. Amateur golfers make a lot of bad shots. But it can happen to professionals as well. In the 2016 Masters golf tournament, reigning champion Jordan Spieth had a comfortable lead on the final day of the tournament. He was cruising toward his second victory. But he mis-hit his tee shot to the 12th hole, and it plunked into the water in front of the green. Then, he "chunked" his next shot—he hit it "fat"—and it went into the water again. His next shot went into the sand trap behind the green. He ended up with a 7 on that par-3 hole—a quadruple bogey. You can watch the entire painful episode on YouTube.

Charles D. Ellis, in his book *Investment Policy: How to Win the Loser's Game*, used these analogies to explain why most people do not win when it comes to investing. Ellis explains that even when top tennis players compete against each other, they are so evenly matched that their winning shots tend to cancel each other out (both make roughly equal winning shots), and the match victory comes down to a critical unforced error.

"PROFESSIONALS WIN POINTS; AMATEURS LOSE POINTS."

Dr. Simon Ramo

It is hard to win, but it is easy to lose.

This concept applies to most other sports—football, basketball, golf, bowling, etc. Penalties, turnovers, fouls, and gutter balls are all examples of unforced errors. Most experts will agree it was more that the Atlanta Falcons lost the 2017 Super Bowl, rather than the New England Patriots won, even though it was an amazing comeback. If Atlanta had not committed several unforced errors (coaching decisions, a fumble, and a holding penalty) late in the fourth quarter, the Patriots could not have come back, and the Falcons would have won easily. During "March Madness," college basketball coaches repeated ad nauseam in interviews that their teams must minimize mistakes (turnovers, fouls, and missed free throws) in order to win. It sounds boringly repetitive, but it is absolutely true.

With respect to investing, many investors–professional and amateur alike–lose because of unforced errors.

They make decisions which adversely affect their rate of return. Their outcome is determined by their losing behavior, not the markets, according to Ellis. Ellis points out that very few professional money managers consistently beat their benchmarks because they are competing against many other very smart, talented money managers. Sooner or later, they will commit an unforced error.

Bill Miller, former manager of the Legg Mason Value Trust, famously (or infamously) set the all-time record for beating the S&P 500 Index from 1991 to 2006, an incredible 15 years in a row—the only U.S. equity fund manager to have ever done so. The streak came to an end in 2006. In a January 2007 letter to investors, Miller said, "…we made some mistakes…" The next year, Value Trust dropped 7%, making it one of the worst-performing funds in its category, while the S&P 500 Index gained 5%. But the worst year was 2008, when the fund fell 55%, much worse than the 37% loss for the index. Why? Unforced errors. Miller invested in Bear Stearns, AIG, Freddie Mac, and Fannie Mae and refused to sell, even as the financial crisis was getting worse. Behavior, decisions, mistakes, unforced errors.

But this example from Bill Miller is not that unusual, although it is extreme. The fact of the matter is that most money managers have been losing the money game. In Ellis' words, most "investment managers aren't beating the market — the market is beating them." According to Ellis, "the only way to beat the market, after adjusting for market risk, is to discover and exploit other investors' mistakes. But very few investors have been able to out-smart and out-maneuver other investors enough to beat the market consistently over the long term."

The overwhelming evidence consistently shows, year after year, that even the most competent professional managers make mistakes and none are so uniquely intelligent that they can profitably exploit other managers' errors consistently. The plain fact of the matter is that too many very smart and talented participants are competing in the game. They can't beat the market because they are the market! That said, a large chasm exists between amateurs and professionals with respect to skill and ability. Individual investors' unforced errors are frequently conflated with emotional speculations. That is why they lose. And, unlike amateur golfers and tennis players, amateur investors must compete on the same field as the professionals at the same time.

Do you think you could beat Jordan Spieth in a game of golf?

Some personal finance TV personalities, websites, blogs, and books tout market-beating strategies, promoting the wonderful fantasy that you can best the professionals at their own game. But seriously, if a market-beating strategy actually existed, Wall Street's largest firms would engage in a frantic bidding war, the winner would purchase it for a small fortune and make a large fortune hand-over-fist. Average investors would be the last to know. So, this is one example of an unforced error in investing; that is, thinking that there is some secret to beating the market. There is no secret. It does not exist.

What are some other unforced errors And mistakes amateur investors commit?

- Keeping too much in cash due to fears of a market meltdown
- Selling stocks because of political mood swings
- Buying a few individual stocks that will supposedly outperform
- Holding on to a stock because the tax on the gain would be so high
- Thinking that a simplistic index fund or two captures all of the returns of the entire global market
- Not selling a stock due to sentimental reasons ("I inherited it from my father," "I worked at that company for decades")
- Getting out of the market because of some geo-political crisis
- Making any investment decision based on media stories or reports
- Thinking that you know something that everyone else doesn't already know—especially professional money managers
- Having too much in large cap U.S. stocks, and not tilting toward small caps, value stocks, and international stocks
- Thinking that last year's winners will continue to prevail, or that last year's losers will continue to trail
- Over-estimating the frequency and severity of stock market declines, and under-estimating the speed and size of market recoveries
- Thinking that a round number (such as Dow 20,000) has any meaning at all
- Devoting a significant portion of a portfolio to gold because of doomsday predictions by someone—even if that someone is very smart
- Buying any investment that promises stock-market-like returns with zero risk

Yet year after year, amateur investors continue to make these unforced errors and continue to underperform. So, how do you avoid losing at the investment game? Stop committing unforced errors. It takes emotionally disconnected discipline.

By "losing" we do not mean an occasional, temporary drop in the value of a portfolio. Stocks and other asset classes are volatile and they will, of course, experience a loss from time to time. In this context, the term "losing" means underperforming. Consistently underperforming will have a serious, permanent detrimental effect on wealth accumulation and living the way you want in retirement. Consistent underperformance is a permanent loss; a temporary drop in value is, well, temporary. Risk and return are related. However, too many investors are not receiving the return they should be receiving for the level of risk they are taking. Why? Unforced errors.