Coincidence or brilliance: how to assess investment decisions

It is often very hard to distinguish between brilliance and dumb luck. Incredibly brilliant people can sometimes be plagued with bad luck. For example, Walt Disney had to file for bankruptcy in 1920 when his then company, Laugh-O-Gram drowned in debt. Steve Jobs was forced out of Apple in 1995, and Albert Einstein got a 5 out of 6 grade in his Chemistry class in 1878.

However, for each of these examples, there are also the opposites that are true, people who were thought to possess unique talents and skills but ended up having only been lucky. One such person was famed investment manager Garrett Van Wagoner, who had reached celebrity status in the late 90s and was described as 'a modern-day alchemist'. Wagoner's assets under management grew from a mere $189 million to $1.5 billion in the space of just a year as investors battled to get in on some of his staggering returns. However, his luck ran out when the dot com bubble burst, and with it came devastating losses and the eventual closure of his fund.

This brings us to the March of 2021, just 12 months since the market bottom and while we are still at a preliminary stage in assessing the damage of the pandemic, the market has clearly looked past the bad and moved forward to the next phase. Since the beginning of the new bull market, the S&P 500 has gained over 75% and with that has come a flood of new interest in investing. According to FINRA Investor Education Foundation, which surveyed several thousand participants,

57% had opened a taxable investment account since March and among them

66% were new investors.

This comes as no surprise with the popularization of 'low-minimum' trading apps, like Robinhood, which has been installed 17.7 million times worldwide, an increase of 157% compared with the prior year. The message conveyed by them and new investors is one of empowerment and that it provides access to look after one's own interests. The issue with empowerment is that it sometimes gets

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misconstrued as control. With investing, one never has control and often times an outcome is thanks to sheer luck. If we fail to recognize how success is derived and especially quick success, it becomes a strategy for failure in the long term. Below are a few thoughts to help avoid this pitfall and become a better decision maker and thereby better investors.

Accepting randomness

As humans we have an irresistible urge to seek patterns in our disorderly world. The markets are no different and it is important to accept that they are filled with randomness that can distort short term outcomes. Time and again it has been proved that the majority of stock price changes are nothing more than random jitters in the system for which no explanation is ever required – yet you can find people obsessing over every minuscule movement and explaining them like kids spotting animal shapes in the clouds. This isn't just the by the minute but over days and potentially months as well.

Roulette and the market have remarkably similar statistics when it comes to randomness. In roulette, the probability of a given throw to hit red or black is 47% and since there are 2 neutral ones this gives the house a 53% probability. The tiny difference of 5% gives the casino a significant advantage over a large number of spins of the wheel. In other words, the house always wins in the long run. Fortunately for investors, there is no need to own a casino to have the same winning advantage; the stock market can offer the same benefit because of a long-term "upward bias." Over the past 50-years through 2020, the S&P 500 daily close was in positive territory 54% of the time – nearly identical to the casino's winning percentage in a roulette game (Crestmont Research). However, this winning advantage only becomes evident over a long period of time. Over shorter time periods, the market can appear very irrational and unpredictable – a bit like tossing a coin or rolling dice. Those who attempt to time the market could, by chance alone, be proven right on a good few occasions, thereby reinforcing their false sense of confidence about the effectiveness of their strategy. But in the long term, market timing is more like playing with a roulette wheel where the market is the casino with a slim winning advantage.

You can't tell the quality of a decision based on the outcome

We are blind to alternative histories – those silent events that could have happened but didn't. In behavioral finance this irrationality is known as Survivorship Bias. The outcome which is visible 'survived' and the ones which didn't survive are hidden.

> One example that faced a lot of controversy was the pass that ended Superbowl XLIX. Late in the fourth quarter, the Seattle Seahawks were at the one-yard line with moments left to play in the game and on the verge of winning their second straight NFL title. To take the lead and win, all Seattle had to do was hand Marshawn Lynch the ball and let him run it in. Instead, Pete Carroll had QB Russell Wilson throw a short pass, which was masterfully intercepted. The stunning turnaround cost Seattle the game and gave the New England Patriots the Super Bowl win. Many articles the next day called it the worst call ever and asking how Pete Carroll could make such a terrible mistake. In a vacuum it might have looked like a bad decision but Benjamin Morris from FiveThirtyEight and Mike Sando noted that within that season on the 1 yard line, QBs threw 66 touchdowns with no interceptions prior to Wilson. While the outcome was poor, probabilistically it was a good decision with a clear established process. But it can be impossible to know if luck (or in this case bad luck) or proper decision making is the deciding factor over a small number of trials.

With investing, and clearly in football, there are no actions one can take to have an outcome that is sure to work

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and no strategy that is always a winner. So the best one can do in activities where luck plays a strong role is to focus on process. Annie Duke who for many years was the best known female poker player and completed her coursework and dissertation for a Ph.D. from University of Pennsylvania, authored *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts*. Duke wrote, "Improving decision quality is about increasing our chances of good outcomes, not guaranteeing them... What good poker players and decision makers have in common is their comfort with the world being an uncertain place. They embrace the uncertainty and, instead of focusing on being sure, they try to figure out how unsure they are, making their best guess at the chances that different outcomes will occur."

Adapting to the environment

Accepting randomness and developing a process – by analyzing available information as well as addressing potential unknowns – is still not enough to be an optimal decision-maker because this leaves us at a static result in an ever-changing environment. As humans we are creatures of habit that enjoy routines and our brains constantly look for the least uncomfortable path. However, by not challenging our thinking frequently, it can lead to outdated assumptions and with investing, potentially be the cause of catastrophic financial loss. One example is the "value trap" which refers to a situation that, on the surface, appears to offer an investor the opportunity to acquire a stock at a significant discount from previous trading levels, promising a chance to own it a lower multiple than its peers, but it turns out to be an illusion due to any number of factors.

Take Blackberry for instance, the once king of the smartphone. They controlled 50% of the smartphone market in the US and 20% globally and sold more than 50 million units at its peak in 2011. When Obama became president he was adamant to be able to keep his beloved Blackberry, which was a huge NSA concern at the time, and became a big deal. In the mid-2000s, BlackBerry phones were everywhere. But demand rapidly declined, and in 2016, BlackBerry stopped manufacturing its own phones. At their height, the stock price was $143 and over time reached $3 in the beginning of 2020. How could a company have that much power to becoming nearly obsolete in a matter of 5 years? The conclusion by most is that the inventor of the BlackBerry was too unwilling to revisit his assumptions to challenge the iPhone before it was too late. The old adage of 'buy low sell high' only works in hindsight as one does not know if a price is truly 'the low' until it has been replaced by a much higher price in the future.

Adam Grant, organizational psychologist and professor at Wharton, recently came out with his newest book, *Think Again*. In it he had a choice quote, "Intelligence is traditionally viewed as the ability to think and learn. Yet in a turbulent world, there's another set of cognitive skills that might matter more: the ability to rethink and unlearn."

Accepting randomness, basing process on more than the outcome, and rethinking our beliefs is not easy. It goes against our human nature of disliking uncertainty, pattern recognition, and having conviction. However, by viewing investing through a more realistic lens of the world by assigning probabilities instead of binary outcomes it incorporates all three of these actions. It allows us to be more open-minded and throw out market noise; it makes room for weighing the unknown and different variables; and finally it allows for growth in our thinking rather than living in a world of right and wrong, cheap and expensive. Although there will never be certainty, developing a better decision making process will increase our probability of long term success in both life and investing.

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So how can you tell if you are brilliant or just plain lucky? With a double shot of humility, a willingness to re-examine your decision making process, openness to possible alternative outcomes, and a side of optimism about the future.

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