Relative Strength at Work, Vol. 9: Playing the Loser's Game

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Introduction

In 1975 Charles Ellis wrote an article in the Financial Analysts Journal entitled "The Loser's Game." Over 40 years later is still widely referenced by financial professionals and experts throughout Canada and the US. I would encourage you to read the original article at your leisure. Although the article is liberally sprinkled with nuggets of wisdom(1), the two most noteworthy conclusions that Mr. Ellis put forth were the following:

1. Contrary to their oft articulated goal of outperforming the market averages, investment managers are not beating the market: the market is beating them.
2. Investing, like tennis, golf, or even war, is not one game but two; a Winner's Game and a Loser's Game. In the first, you try to beat your opponent with brilliant, bold moves; in the second, you play conservatively and let your opponent beat themselves.

Market Beat-Down

His first point is nothing new to investors today. But at the time, it was remarkable in the sense that he acknowledged it wasn't enough to simply be brilliant, hard-working, and well educated. It **used** to be enough (in the 60s and early 70s), but for various reasons he cites it was no longer the case.

Some of those reasons he cites are no longer valid. For instance, it costs nowhere close to 3% for institutions to buy or sell a security today. But despite the fact that transaction costs have come down since 1975 his conclusion is still valid. Most investment professionals (by which we would include advisors, financial planners, portfolio managers, institutional fund managers, and so forth) do not consistently beat the market. According to Nomura(2) at the end of June, 2016 only 6% of U.S. active equity fund managers outperformed the S&P 500 index based on trailing five-year performance after fees.

Mr. Ellis gives four suggestions to the professional fund manager as to how to get into this elusive 6% club. But before we dive into that, we first need to examine the crux of his article – that of defining the difference between a Winner's Game and a Loser's Game, and how it applies to investing.

To do this, Mr. Ellis cites the work of three disparate experts; scientist and author Dr. Simon Ramo, naval historian Admiral Samuel Morrison, and pro golfer Tommy Armour.

The Winners' Game and Losers' Game, Defined

Dr. Ramo wrote a book on playing strategy, *Extraordinary Tennis for the Ordinary Tennis Player*. Over many years, he observed that tennis was not one game, but two. In the first version played by professionals, the ultimate outcome is determined by the actions of the winner. In other words, victory is due to winning more points than your opponent wins. He refers to this as the Winner's Game. In the second, the victor gets the higher score because his opponent makes more errors than he does. This is referred to as the Loser's Game. The ultimate conclusion by Dr. Ramo is that for most tennis players, the most reliable strategy for winning is to focus on reducing errors, as opposed to striving for brilliance. Keep your play simple and allow your opponent to blunder his or her way to defeat.

In his book *Strategy and Compromise,* Admiral Morrison makes the following point: "In warfare, mistakes are inevitable. Military decisions are based on estimates of the enemy's strengths and intentions that are usually faulty, and on intelligence that is never complete and often misleading."

Sound familiar?

Let me rephrase: "In *investing*, mistakes are inevitable. *Buy/sell* decisions are based on estimates of the *company's* strengths and intentions that are usually faulty, and on *analysis* that is never complete and *management guidance* that is often misleading."

"Other things being equal," concludes Morrison, "the side that makes the fewest strategic errors wins the war."

Tommy Armour repeats this theme in his book *How to Play Your Best Golf All the Time*. "The way to win is by making fewer bad shots. Play the shot you've got the greatest chance of playing well."

It should be mentioned that Mr. Ellis is not passing judgement on which game is the better game to play – the Winner's or the Loser's game. The Loser's game in this context is not derogatory. It's a simple way of explaining conceptually *how to play the game to win*.

For instance, he references studies that show the best offensive players in football "play a careful, by the book style that concentrates on avoiding errors and eliminating uncertainty, which is the requisite game plan for a Loser's Game. 'Keep it simple,' said Vincent Lombardi." He is obviously not calling NFL players losers; he's just identifying the style of game they're playing.

Sources of Investment Error

Now, mistakes are obvious in football, tennis, and golf.

But what about investing? What type of mistakes are we talking about avoiding? The irony we sometimes see with attribution of success by investors is that when a decision leads to a profit, it's because they are brilliant – but when they lose money, it's because of some 'unseen, unexpected surprise that no one could have seen coming!' So for the sake of simplicity and humility we are going to suggest that making a mistake means losing money, no matter 'why' we lost it. This applies to all investors, professional or amateur. This has two applications – mistakes leading to losses on individual positions within the portfolio, and those that lead to losses on the portfolio as a whole.

In practical terms, making or losing money on your investments are derived from a few basic decisions:

1. Portfolio Management: what do I buy, when do I buy it, and when do I sell it and buy something else? There is no single right answer to these questions, although we have witnessed many wrong answers over the years.
2. Diversification: The most common mistakes here are:
    a. Too many positions that are all highly correlated,
    b. Too few positions,
    c. Too many small positions such that the outperformance of your winners have a negligible effect on the portfolio.
3. Position Sizing: How much of my money do I allocate to each position? If it's too small, then my expected profits will also be too small to matter. If it's too big, then any large loss wipes out my gains from my other positions.

That's it! Nearly all of the investment decisions leading to a gain or loss in your portfolio are captured in the preceding three core tenets.

We didn't mention behavioral biases as a source of error in the investment process even though they can have an impact on your results because they are more of a derivative of these three decisions. For instance, belief in an analyst price target on a particular stock you own (an example of Anchoring Bias) may affect your sell decision (as you hang on longer than you should), and possibly your position size (if you buy more than you originally decided to because it's priced at a large discount to that price target). If you had rules and followed them your bias would have no impact on managing the portfolio. Other, more common biases that can lead to investor errors are;

- Confirmation bias: searching for information that supports your beliefs and ignoring contradictory data.

- Overconfidence bias: belief in the superiority of your own abilities compared to others.

- Gambler's Fallacy: continually investing/speculating in high risk positions due to the belief that 'eventually I'll win again'.

So if these decisions ultimately decide whether you win or lose at the money game, what can we do to increase our odds of making money?

Mr. Ellis gives four tips for those 'determined to win the Loser's Game'. We summarize them below and give examples of how we have incorporated these concepts into our particular investment process.

How to Win the Loser's Game

"First, be sure you are playing your own game. *Know your policies* (i.e. your process) *very well and play according to them all the time."*

If you are a long time reader of our Relative Strength at Work articles, you may have noticed we only talk about the one thing that constitutes 'our game' – Relative Strength. We don't talk about earnings, cash flow, valuations, return on equity, dividend yield, and other traditional fundamental data. We understand these things. We know what they are. But as anyone who has managed money professionally may tell you, they don't really give you a reliable edge (because if they did, 94% of these brilliant well-educated fund managers who use fundamentally driven analysis wouldn't be underperforming!) So for us, we ignore them. We play our own game, with our own process that we know very well, and we play by these rules all the time.

***"Second, keep it simple.** Ramo says 'Every game boils down to doing the things you do best, and doing them over and over again. Armour says 'Simplicity, concentration and economy of time and effort have been the distinguishing feature of the great players' methods, while others lost their way to glory by wandering in a maze of details.' In short, do a few things unusually well."*

What could be simpler than managing an investment portfolio based on something as easy to understand as supply and demand? There is no analyst target price to get caught anchoring to. We don't have to understand corporate balance sheets and income statements to verify the credibility of management guidance because we don't care what management says. We have no beliefs on the outcome of the particular security we are buying other than the fact the odds are more likely it will go up in price than down. There is no maze of details to get lost in because the process is intentionally uncomplicated. We have eliminated the danger of paralysis by analysis.

***"Third, concentrate on your defenses.** Almost all of the investment managed business is orientated towards purchase decisions. The competition in making purchase decisions is too good. Concentrate on selling instead. Almost all of the really big trouble you're going to experience in the next year is in your portfolio right now (*as we talked about in Valeant Pharmaceuticals*); if you could reduce some of those really big problems, you might come out the winner in the Loser's Game."*

We've gone to great lengths to articulate our sell discipline in previous relative strength articles for this very reason (Finding the Sweet Spot, and The Sweet Spot Revisited). First, so you can understand how it works and why we do it. Second, to make the point that we actually have one! Do you? Could you define it in ten seconds or less? Is it easy to execute? If you pause and reflect on every major investment loss that you've suffered personally or witnessed publically, in nearly every case that BIG loss started off as a SMALL loss. That's what a sell discipline does for you when applied with effective position sizing. If you want to win the investment game, put more time and effort into learning how to be a good seller.

"Fourth, don't take it personally."

It is the nature of investing that there will be periods of time where it seems like you just can't get a break. All your efforts are for naught. Bad stuff happens, and then more bad stuff happens. It's during times like this that your faith in your process will be tested. You can't take it personally. No process or investment strategy works all the time in all types of markets. We felt it too, and was the catalyst for writing Process Over Outcome last summer. If you find yourself here take a deep breath, resist the temptation to 'cheat' and deviate from your rules because they're "not working", and remain disciplined.

Wrap

I'd encourage you to save a copy of Mr. Ellis' "The Loser's Game" for future review. It is a timeless piece that I still see referenced today, and the concepts and principals discussed will help you understand what differentiates a good investment process from a bad one. I personally print off his article every couple years and re-read it when I'm on vacation, or when I feel the need to re-center my thoughts. It serves as a useful reminder to:

Win by not losing. Know your process well and don't deviate. Keep it as simple as possible to avoid getting lost in the details and when the road gets bumpy, as it always does, stay resilient.

We appreciate any feedback you may have on this article, and as always, make every year count!

<u>Footnotes</u>

(1) Nuggets of wisdom from Charles Ellis:

- "The investment management <u>business</u> (it should be a profession, but it is not)…" {ed: emphasis added}
- "Faced with information that contradicts what they believe, human beings tend to respond in one of two ways. Some will assimilate the information, changing it – as oysters cover an obnoxious grain of silica with nacre – so they can ignore the new knowledge and hold on to their former beliefs; and others will accept the validity of the new information."
- "After many hours of discussion with protesting money managers all over America and in Canada and in Europe, I have heard no new evidence or persuasive appeal from the hard judgement that follows the evidence presented below. In brief, the "problem" {ed: under-performance} is not a cyclical aberration; it is a long-term secular trend.

(2) Nomura Quant Strategy, "Peak Passive", January 5, 2017.

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