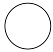

MY BEST PICK 2021

The million-dollar question: Is investing a game of luck or skill?

The success of outliers are marketed well, to sell the virtue of the game. Do not be fooled

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Over a period of time, a certain school of investing has dominated all investment thought — the Warren Buffett School of investing.

What exactly is it?

In essence, it comes down to this. Buy a small group of high-quality, branded consumer companies that have pricing power (the ability to raise prices without affecting demand much), and companies which have strong “moats”, that is, companies whose business fortresses are protected by competitive advantages that are hard to breach.

This story has been told over 35 years by Buffett himself. And it has pervaded investment thinking deeply, so deeply that it is considered heretical to question it or even any part of it.

Perhaps the only person who has questioned Buffett’s wisdom has been the legendary Chicago Business School professor and Nobel Laureate Eugene Fama.

Outlier Oracle

Fama’s view has been that Buffett is a purely statistical phenomenon, an outlier.

Let me explain what that phenomenon would look like: if you get one million people to play the stock market, using any method that they want, there is a certainty that a very small number of these people will get fabulously wealthy. That is nothing but a simple probabilistic outcome.

Probability theory dictates that when a large number of people play a game, a very small number will emerge as the statistical outliers, or the winners. It is these statistical outliers that are then played up in popular imagination, to extol the merits of the game, which draws the next one million into it.

The story then repeats with a handful of fresh millionaires, born out of the second one million players.

According to Fama, Buffett represents that “handful” of people out of the millions, who become fabulously wealthy through the stock market.

Why the game at all?

If only a miniscule percentage of people become truly wealthy through the stock market, what is indeed this game of investing? Is it a game of luck as the statistical probabilities above show, or is it a game of skill? This is a question we pose to ourselves every day as fund managers, and it has some interesting aspects to it.

We bought Amazon in 2001 at the depths of its crisis. The price then was around $15. The stock is now around $3,000 and we sold the last of our holdings in the last few months.

Was this fabulous 200-bagger trade, a trade of luck or a trade of skill?

Let us analyse the rationale for the investment first. We turned bullish on Amazon for two major reasons back then. One, the company had turned free-cash positive in that period, after bleeding cash for its entire history. Two, and equally important, was the uniform negative opinion on Amazon on Wall Street. Lehman Brothers' lead credit analyst, Ravi Suria, had downgraded Amazon bonds stating that they were going to default.

Mary Meeker, The High priestess of Internet 1.0, had been with Morgan Stanley, and wrote a piece on Amazon, titled *Throwing in the towel on Amazon*. In another, Business Week had a cover around the same time with the heading "*Can Amazon survive?*"

A great trade was born. And the rest is history.

But back to the question: was it luck or skill? When we look back, out of the total gains of around $2,980 on the stock, we would attribute around $50 to skill.

By this, what we mean is it was fairly easy to predict a doubling or even tripling, if not quadrupling, of the stock from the depths of despair. This is because, when a debt-laden company, given up for dead, turns around by positive cash generation, it is almost certain that the stock will rally massively.

History is replete with several such examples of beaten-down stocks, which when they get even a glimmer of hope, stage magnificent rallies. So the journey from $15 to $60 can be attributed to skill. But the remainder of the journey from $60 to

$3,000?

Come on, that is pure luck! Nobody in their right mind could have predicted that Amazon would become $3,000 and one of the most valuable companies in the world. Not even Jeff Bezos could have done that.

Therefore, if one were to dissect the element of luck and skill in this investment, one can see that 98% of the profits made came from luck and only 2% came from skill!

The other way to look at this whole debate of luck and skill is to dissect the returns of any fund manager over a period of time. If the returns are concentrated in a handful of stocks, while most of the stocks have not contributed much or have actually detracted from the overall returns, one can safely say that this fund manager or investor's returns are largely a product of luck and less a product of skill. When returns come from a tiny handful of somebody's holdings, that is nothing more than a generous dose of luck at work.

That person or fund manager can be called the "survivor". In other words, he is the guy who has won the lottery as opposed to the millions who are destined to lose money in the lotteries. As Charlie Munger candidly admits, "If you take out Berkshire's tiny set of companies that have delivered most of our returns, we are left with very mediocre returns on the majority of the portfolio."

It is hard for a major fund manager to be as honest as this.

Without saying it in so many words, what this amounts to is that Buffett, and a few others, are the "lucky" survivors of a game in which the majority will lose. All because the way the majority plays the game is all wrong.

Check the strike-rate

A game of skill, by necessity, means that you are hitting an average of 55% to 60% winners in your portfolio. Almost every storied investor runs a strike rate of anything between 1% and 10%! Yes, that's it.

A US study of 20,000 venture-capital deals over several years revealed that only 0.5% of the deals ended up being 50 baggers! Now if that is not luck at play, then what is?

This analysis leads to some interesting conclusions on how most mutual fund managers, as well as other money managers and individual investors, will randomly have periods of great runs. This is when they will be said to have a Midas touch, a “hot hand”. This period of pure luck is marketed and masqueraded as skill.

It is like consistency in cricket: a batsman who gets to an average of 50, by making zeroes in four innings and a 250 in the fifth, will be largely a product of luck or randomness, while a player who gets 50 each in five innings will be called a player with skill.

Always analyse this aspect of any fund manager or investors’ return profile and you will understand what is at work in terms of driving their returns.

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