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Why following successful investors may set you up for failure - Part 2

Synopsis
The most successful outliers on Dalal Street or for that matter, Wall Street over any given short-term period almost always took some extreme amount of risk that just happened to pay off big.

Devina Mehra
Chairperson and Managing Director, First Global

Devina Mehra is the Founder and Chairperson of First Global, a leading Indian and Global investment Management firm, managing both PMS schemes in India as well as global funds.

She is a gold medalist from IIMA and Lucknow University. Has been in the Investment business for over 30 years, including running a global business for nearly 25 years.

She has been quoted widely on Global as well as Indian markets by global financial media like Wall Street Journal, Barron's, Business Week, Fortune, Forbes, CNBC, Financial Times etc.

She tweets @devinamehra and can be contacted at info@firstglobalsec.com or www.firstglobalsec.com

This is a really fascinating story about World War II.

The US military was examining where to reinforce its bomber aircraft. The aircrafts returning to the base were examined to see which parts had taken the maximum hits and plans were afoot to reinforce these parts.

That is when mathematician and statistician Abraham Wald pointed out that this analysis was likely to be totally off because it did not take into account the aircraft that did not return to base.

The parts which showed no hits were probably the parts where, if the aircraft took a hit, it would not survive and be able to return to base. The bullet holes in the returning aircraft, contrary to conventional thinking, represented areas where a bomber could take damage and still fly well enough to return safely to base.

Thus, Wald proposed that the Navy reinforce areas where the returning aircraft were undamaged, inferring that planes hit in those areas were lost.

It was a brilliant piece of analysis that totally inverted the way of looking at a problem.

A not-so-happy piece of trivia: Wald died in an air crash over Kerala in the 1950s while going from a talk at Indian Statistical Institute at Calcutta to one at the Indian Institutes of Science.

You must be wondering what this story has to do with following successful investors?

In Part 1 of this series we looked at whether the ones we want to follow were successful in the first place and whether they were following the strategies we ‘think’ they were.

But there is something even more fundamental than that.

Are you even asking the right question?

If your starting point is investors that are or appear successful, you start with that list and then you look backward at the strategies they have employed in the past.

You are starting with a success stories of, say, billionaire stock investors or fund managers with great performance, and attempting to reverse-engineer a personal pathway to similar success. The stated or unstated presumption is that if you follow their strategies, you will see similar levels of success.

Now suppose some of these entities/ investors had opted for extremely high-risk strategies, where most of those using these strategies went out of business. However, the few that were left standing became successful or rich beyond their wildest dreams!

But your analysis does not take into account the entities which followed the very same strategy but went out of business.

Or, in short, your analysis suffers from survivorship bias.

You think you are answering the question as to which strategies lead to success but your actual analysis is inverted in order.

What happened to ALL those who followed this strategy?

Instead of starting with what happens to investors or fund managers who follow a particular strategy, you are instead looking at the strategies followed by the successful entities. The two are entirely different questions.

It is the equivalent of saying that in order to become as successful as Bill Gates, the important thing is that you should drop out of college.

It is a core principle of probability that the probability of an event A given that event B has occurred is not the same as the probability of an event B given event A has occurred. By inverting the pathway, you are ending up with a completely wrong result.

An example will make it clearer. Suppose there is a way of investing which is extremely high risk but can give better returns. Say, every year 90% of the people opting for it will go bust, but the balance 10% will make 10 times their money.

Suppose 100,000 people start playing this game. 5 years later there will be only one person left out of these but this person would have made $1,000 into 100 million dollars. She will be the most successful investor in the market.

Now when you are evaluating options and know of this person who has converted $1,000 into 100 million dollars, you would naturally want to emulate her methods except that due to survivorship bias you will not realise that 99.999% of people opting for this method or system will go bust.

Only the Optimistic or Risk-takers make money?

Think about this very deeply when you hear that all the richest investors in the world are optimistic or risk-takers or whatever the defining characteristic is supposed to be.

In general, only a few investors that follow the most aggressive strategies will make extraordinarily high returns whereas the others will flame out.

Outliers take extraordinary risks to produce those magnificent returns.

The most successful outliers on Dalal Street or for that matter, Wall Street over any given short-term period almost always took some extreme amount of risk that just happened to pay off big.

But, just because a particular strategy worked one time for one person at a particular point in time does not mean it is a good strategy to follow.

It’s unlikely that someone who has an investment strategy that generates a significantly higher return than the market has found a strategy that is safe and consistent.

More than likely, that he or she has simply “survived” a very dangerous approach to investing - in short they got lucky.

It is like meeting a centenarian who has been drinking and smoking and eating lavishly all her life and assuming that following a similar lifestyle will get you to live to 100. It is not going to happen.

That particular person may have been extraordinarily lucky in terms of her genes or some other factor and is actually the exception that proves the rule.

And the role of chance

Even when the odds are not as extreme as in the example above, there is a general rule that holds. If you look at only the picture of who has made the most returns we would say that being extremely aggressive is good.

In reality, maybe 90 or 95% of those who had these aggressive positions lost all their capital. And there are maybe 5% who made outsized returns.

Even for systems that are not as high risk as this, due to the sheer chance, there will be some people who will make extraordinary amounts of money but even that does not mean that the system that they followed was the best system to follow or would give the best risk-return trade-off.

Between the previous article and this one it should be clear to you that just following the tactics of well-known or successful investors and funds managers is usually not the way to Nirvana. In fact, it can take you in the reverse direction.

Note: This is part 2 of this series of columns.