

What Babe Ruth and Blackjack Can Teach Us About Investing

Michael Mauboussin

Legg Mason Capital Management Group



Some of the smartest stock market strategies can be gleaned from games—blackjack, poker and baseball. Finance professor Michael Mauboussin has studied the habits of great gamblers and baseball players to learn how to make better decisions. His favorite lessons...

STICK TO YOUR GUNS

Baseball executive Paul DePodesta is featured in the best-selling book *Moneyball* by Michael Lewis. He tells about the time he was playing blackjack in Las Vegas when a man to his right, sitting on 17, asked for a hit. Everyone at the table stopped in surprise. The next card he was dealt was a four. *Twenty-one. Blackjack!* Everyone congratulated the player for his skill and courage, but DePodesta realized that the big winner was really the dealer. *Reason:* Any blackjack player whose strategy is to hit on 17 is going to make the casino very happy over time. The dealer prevails because he/she relies on a consistent, low-risk strategy based on probabilities, while gamblers find it more exciting to take bigger risks.

This illustrates the fundamental concept of “process versus outcome” in investing. Too often, investors dwell solely on short-term results. *Example:* You may start your mutual fund research by looking at the funds that had the highest returns over the past year. This is a mistake—superior long-term performers are rarely the best or worst in any given year.

Instead, focus on a fund’s investment process. If it’s sound, the results will take care of themselves. Look for...

■ **A firm that focuses on investing as**

opposed to growing its business. The firm should have an intelligent and consistent system for identifying stocks. It’s no coincidence that many fund companies that have trounced the major indexes over 10 years or more are run by smaller companies located outside the country’s investment centers, New York City and Boston (home of fund giant Fidelity Investments). These companies include Wasatch Funds (Salt Lake City), Longleaf Partners (Memphis), Weitz Funds (Omaha), Dodge & Cox (San Francisco), my firm, Legg Mason Funds (Baltimore) and Mairs and Power Funds (St. Paul).

■ **A concentrated portfolio**, usually with 40 or fewer stocks. Owning few stocks is a sign that the management team has conviction about its picks and knows them in depth. Funds with hundreds of stocks begin to resemble index funds—and there’s no reason to pay an active manager’s fee to replicate an index.

■ **Lower-than-average expenses and portfolio turnover.** US stock funds have average expenses of 1.4%, according to Morningstar. Turnover—the percentage of a fund’s holdings that have ▶

Bottom Line/Personal interviewed Michael Mauboussin, senior vice president and chief investment strategist, Legg Mason Capital Management Group, Baltimore. He is coauthor of *Expectations Investing* (Harvard Business School) and adjunct professor of finance at Columbia Graduate School of Business, New York City.

Until recently, he wrote the quirky monthly newsletter *The Consilient Observer*, whose subscriber list included Amazon.com’s Jeff Bezos and mutual fund legend Bill Miller. Back issues are available at www.capatcolumbia.com/Consilient.





▶▶ changed over the past year—averages 95%. A fund that has 25% turnover holds each stock for four years, on average. Funds that trade frequently tend to have high expenses.

■ **Substantial personal investments by the fund's managers.** A mutual fund's prospectus must disclose the dollar amount of the managers' own investments in the fund, if any, as well as the structure for earning bonuses.

MAKE SMART BETS

When asked about the best investment advice he ever heard, stock-picking guru Bill Miller, portfolio manager of Legg Mason Value Trust, which has beaten the S&P 500 Index annually for the past 15 years, quoted Puggy Pearson. The three-time winner of the World Series of Poker and a top gambler said, "Any donkey knows there ain't only three things to gambling—knowin' the 60-40 end of a proposition...money management...and knowin' yourself."

Let's deconstruct Mr. Pearson's sage advice...

■ **Knowing the 60-40 end of a proposition.** Investing is the constant search for asymmetrical payoffs, where the upside potential exceeds the downside risk. Never invest unless you (or your fund manager) know something that the market doesn't—based either on superior information, such as your knowledge of a specific industry, or analysis. *Example:* Warren Buffett invests only when he feels he has a high probability of success, and even then, only in industries with which he is familiar—in particular, insurance, manufacturing and retailing.

■ **Money management.** How much money do you put behind a winning proposition? Pearson knows never to bet everything on a single hand. However, the greater your confidence level, the larger your bet can be. It's the same with investing—the larger your margin of safety, the more money you should devote to a particular stock or fund.

■ **Knowing yourself.** Understand your particular weaknesses and decision-making patterns when you are under pressure. You can't analyze your mistakes unless you keep a record of the process you go through when you make

a trade. For instance, do you tend to jump in after a market run-up for fear of missing profits? Or do you fall in love with a stock and hang on too long, even as its prospects grow dim?

Once you isolate your weaknesses, you can address them. Keep a log of trades, and track your performance. For instance, if you discover that you sell stocks prematurely, establish objective rules for when you should sell in the future, such as when a stock has reached your estimate of its fair value...when your theory about a stock has been proven wrong...or when a better opportunity appears.

SWING LIKE BABE RUTH

Even though Babe Ruth struck out nearly twice as often as he hit home runs, he is remembered as one of baseball's greatest hitters. Why? The frequency of success in hitting home runs doesn't matter as much as the magnitude of success. The same is true for picking stocks. *Example:* You own four stocks. Three go down a bit, but the fourth rises substantially. Overall, my studies suggest that a portfolio can perform well even if the majority of its holdings decline. When making choices, most people exhibit a significant aversion to losses, no matter how small the stakes. Big home run hitters don't expect to get on base every time. Likewise, to build a portfolio that can deliver superior returns, you must not focus on being right all the time but on letting your winners ride and selling off losers quickly.

UNCONVENTIONAL BOOKS ON INVESTING

Moneyball (Norton) by Michael Lewis. Even with the second-lowest payroll in baseball, the Oakland As have become a leading team by consistently identifying great players, much the way that top investors uncover winning stocks. This is an excellent primer on decision making and asset allocation.

Super Money (Warner) by Adam Smith, founding editor of *Institutional Investor*. It came out during the horrific bear market of 1973, but it could have been published today. It provides valuable lessons on avoiding emotional investing and other psychological pitfalls. ■■