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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Ever observe somebody who has something great happen to them, and think to yourself - "they were just lucky." We all have. But have you ever thought about what makes luck? The usual response is something like – you make your own luck, or, if you show up enough times you will eventually be at the right place at the right time. In his book *The Success Equation, Untangling Skill and Luck in Business, Sports, and Investing,* Michael Mauboussin explores the issue of luck and skill in our lives. His explanation of luck and skill with regards to investing was especially revealing.

We are constantly inundated with self-proclaimed experts in the investment world. It only takes one clairvoyant market call for them to parade in front of the world as the latest market guru. The real issue should be; was it just luck? We all like to see immediate results, but you should really be asking yourself; was I just lucky if the investment I just bought immediately shows an attractive profit? The answer to this question may be one of the biggest drivers to your long-term success as an investor.

Mauboussin postulates that investing, at least in the short-term, is mostly just luck. He states that to become an expert at something, the cause and effect must be clear and consistent in what you do (the condition of validity), and your intense practice is guided by accurate feedback. Your activities must take place in a stable environment so that deliberate practice improves skill. There are two key points that seem to differentiate luck from skill when it comes to short-term investment results. The first is a consistent cause and effect. The problem with investing is that what matters one day may have the exact opposite outcome the following day. Therefore, there is no accurate feedback. The second requirement is for a stable environment. If you want to be a better basketball player, you should probably start by shooting 100 free throws every day. The basket doesn't change, the height doesn't change, the ball is the same. Deliberate practice makes you better. In the world of investing, everything is in constant flux, so short-term success may make you more confident about something that was just luck.

Before you conclude that the stock market is just one big casino, there is a solution. Mauboussin suggests that when activities are more influenced by luck, you won't get the feedback you need in the short-term. What you do is not strongly connected to the result. In this case the best approach is to focus on the process you are using. The simple theory is that as you practice and develop your skill, your results will fluctuate because luck is partially driving day to day events, however, your process will produce results over time. The best investors still experience losses, but the good ones stick to their discipline. Don't count on your intuition, you can't train your intuition when the conditions around you are constantly changing.

There is value to understanding that luck is a component of investing. It becomes somewhat liberating. To admit short-term results are beyond your control can then place your time and energy on your process. A strong process takes skill, and that can be developed. Everyone thinks that winning the lottery is the pinnacle of luck. However, almost all lottery winners when asked a few years later, say it was the unluckiest day of their lives. It changes everything, but they have no process to deal with the change. Their process was hoping they would get lucky.

In an investing environment that doesn't seem to make sense, focus on your process. When the challenging times come, and they always do, a strong process will see you through. Not the luck of whether the market goes up or down the following day.