

## WEDGEWOOD VIEW. 2<sup>nd</sup> QUARTER 2004

### POKER, PONIES AND THE STOCK MARKET

*The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.*

G.K. Chesterton

We in the investment management business tend to read quite a bit. In fact, most of our offices (and a few homes; I speak on good authority here) resemble mini landfills of research reports, annual reports and financial magazines. Call it organized clutter, but there is some method behind the chaotic stacks of papers. We clutterers have stacks for cursory reviews, stacks for more in depth reading and smaller stacks for those rare keeper reads. Every so often that rare gem of a piece crosses our desks that are so cogent, so annoyingly well written, that as we read along we fight back professional envy.

So it was when in late May we sat down to read Michael Mauboussin's most recent epistle. Mauboussin is the Chief Investment Strategist at Legg Mason Funds Management. Before joining Legg Mason in February, he held a similar position at Credit Suisse First Boston. Mauboussin's role as "Strategist" is different (and better) than the typical strategist in this business. Instead of the usual barking prognostications about earnings forecasts and price targets for say, the S&P 500 Index and the industry standard recommended asset allocation, Mauboussin only writes on occasion. His writings always have a distinctly different angle on the wide ranging matter of investing.

Mauboussin's latest piece is entitled *Decision-Making for Investors: Theory, Practice and Pitfalls*. Investing is a "probabilistic field." To be successful in probabilistic endeavors – investing, poker and horse race handicapping – one must become proficient at accessing and understanding probabilities.

Mauboussin summarizes his research as follows:

- *Individuals who achieve the most satisfactory long-term results across various probabilistic fields tend to have more in common with one another than they do with the average participant in their own field.*
- *Distinguishing features of probabilistic players include a focus on process versus outcome, a constant search for favorable odds, and an understanding of the role of time.*

- *Success in a probabilistic field requires weighing probabilities and outcomes – that is, an expected value mindset.*
- *One key to success is a high degree of awareness of the factors that distort judgment.*

Most probabilistic activities are fair, or more precisely, efficient. Such activities tend to be efficient enough that finding consistent winners is difficult. The overriding question is always: Are the winners skillful or lucky? The equally pertinent follow-up question is: Will past winners be future winners?

Mauboussin asserts that “*certain individuals do consistently generate superior results.*”

Mauboussin states further:

*The combination of differential capabilities and existence of superior performers provides a basis for judging skill versus luck. Individuals who consistently succeed in various probabilistic fields possess both superior skills and a dissimilar approach to others. In fact, these super performers appear to have more in common with one another than they do with the average participant in their own field. A great investor thinks more like a great handicapper than the average investor.*

*We want to study the elite performers in probabilistic fields to see what traits they have in common. These traits will provide a guideline to access skill versus luck in the investment business. In short, we need to look outside the investment business to understand skill within it.*

Elite performers share three related attributes: a focus on process versus outcome, a constant search for favorable odds and an understanding of the role of time.

Mauboussin argues that top performers must “*focus on establishing a superior process with the understanding that outcomes take care of themselves.*” Listen to David Sklansky, author of *The Theory of Poker*:

*Anytime you make a bet with the best of it, where the odds are in your favor, you have earned something whether you actually win or lose the bet. By the same token, when you make a bet with the worst of it, where the odds are not in your favor, you have lost something, whether you actually win or lose the bet.*

In the past we have shared our scorn that too many investment firms focus too much, if not exclusively, on short term results. Mauboussin finds that superior investment firms focus on process.

Unlike other probabilistic activities – horse race handicapping and sports betting – an investor must “*read*” those odds offered daily by the stock market by “*deciphering the*

*expectations built into prevailing prices.” We heartily agree with Mauboussin that this critical aspect of investing is by far the greatest single failing of investors – amateurs and professionals alike. The allure of jumping on a hot stock – that often times have already appreciated substantially – is often too much for investors to avoid. All too often short-term performance chasing is ruinous. Mauboussin explains further:*

*Consider the following from Steven Crist, chairman of the Daily Racing Form. Replace ‘horse’ with ‘stock’ and you have an excellent articulation of the challenge many investors face:*

*The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory ... This may sound elementary, and many players may think that they are following this principle, but few actually do. Under this mindset, everything but the odds fades from view. There is no such thing as “liking” a horse to win a race, only an attractive discrepancy between his chances and his price.*

Ted Williams is arguably the greatest odds reader ever to don a baseball uniform. In his classic book, *The Science of Hitting*, Williams describes his assessment of odds by means of a grid. Imagine you are a pitcher facing Williams and each pitched ball travels through a strike zone-grid seven baseball widths wide by eleven baseball widths high. Williams has calculated his average (odds) on each of these 77 pitches close enough to swing. Williams, the last .400 hitter, calculated that out of 77 strike zone pitches only three (barely 4%) would be “.400” pitches. Williams explains further:

*My first rule of hitting was to get a good ball to hit. I learned down to percentage points where those good balls were. But more important, each should learn the strike zone, because once pitchers find a batter is going to swing at bad pitches he will get nothing else. The strike zone is approximately seven balls wide (allowing for pitches on the corners). When a batter starts swinging at pitches just two inches out of that zone, he has increased the pitcher’s target from approximately 4.2 square feet to about 5.8 square feet – an increase of 37 percent. Allow a pitcher that much of an advantage and you will be a .250 hitter.*

Equally difficult is a proper understanding of the role of time. Mauboussin states that, “... dealing with probabilities requires persistence and staying power. In the short term, results may be very unsatisfactory. Long term, an appropriate process delivers good results. You cannot judge performance in a probabilistic field over the short term – there is much too much noise.”

Mauboussin quotes the 1972 World Series of Poker, Amarillo Slim:

*The results of one particular game doesn’t mean a damn thing, and that’s why one of my mantras has always been “decisions, not results.” Do the right thing enough times and the results will take care of themselves in the long run.*

Mauboussin crystallizes his research as it pertains to the investment management process:

***The signatures of a quality long-term process include a focus on economic (versus accounting) value, low turnover and relative portfolio concentration.***

That, in a nutshell, is all we try to do here at Wedgewood Partners. Tony, Dana and I are of course quick to eliminate such words as “elite” and “superior,” but we find nothing to disagree about in Mauboussin’s findings.

Too much research effort is expounded on accounting (quarterly earnings per share to the penny) rather than economic value. Our process is grounded in the understanding of what makes our invested businesses tick more than anything else. Our worst mistakes have been our true lack of understanding of the quality and competitive position of a business rather than being wrong on a quarterly earnings estimate.

Truly outstanding businesses are rare. Once we find one that has a very good chance to be dominate for years to come, we are loath to sell. Our worst mistakes have not been investing in those businesses that we believed were princes, but were really frogs, but in selling those outstanding businesses that may have stumbled over the short-term, but would then go on to prosper for many years to come.

Finally, far too many investors convince themselves that dozens and dozens of stocks in a “perfectly diversified” portfolio not only offer safety, but a means to out performance, they fail to realize that it only takes a few great businesses to turn a portfolio into a winner. Our worst mistakes will always be rounding errors compared to those stocks which can possibly appreciate two, five or more than 10 fold.

We will keep Mauboussin’s piece in our shortest stack of outstanding research reports.

David A. Rolfe, CFA  
Chief Investment Officer

July 2004

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