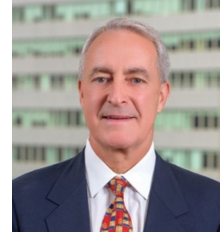

Thoughts for Investors

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"The best way to minimize risk is to think."
– Warren Buffett

Process vs. Outcome

Athletes and coaches agree that it's very hard to learn about your abilities when everything is going your way because you can easily develop a false sense of security. The now almost forgotten bull market was great for building investor's egos but not for honing their skills. Today's market has called into question the abilities of many novice and experienced investors. It seems that even the stocks of good companies, whose prices may already be down significantly, seem to go down even more once you commit to buying. If that happens, can you automatically say you've made a mistake? How do you differentiate between what could be a lack of ability or just bad luck? The ability to tell the difference is a cornerstone of the great investors' success and comes from their willingness to concentrate on the process, not the outcome.

Process is defined as a series of actions, changes, or functions bringing about a result. An investment process is the methodology of how a person invests and is distinct and separate from the outcome. There are many, many potential outcomes that investors seek (based on their goals and objectives). There are far fewer good investment processes, yet investors are constantly bombarded with publications and advisors touting new ones. The general result of all this noise is confusion and therefore fixation on the outcome. Great investors focus all their energy on defining and refining a process, trusting that the desired outcome will follow. While on the surface this may seem counter-intuitive, great investors realize that by and large, good processes usually lead to good outcomes. However, sometimes luck will cause a bad process to lead to a good outcome. More than once I've been fortunate to have my golf ball end up in the middle of the fairway after inadvertently hitting it directly toward the woods. Likewise, good processes can occasionally lead to a bad outcome as when a well struck golf ball ends up in the woods after hitting a sprinkler head in the middle of the fairway. Watch a professional golfer on the driving range. Rarely do they look up to see where the practice ball ends up. They are more interested in whether the process of their swing is correct.

Concentrating on the process involves developing a repeatable, tested, consistent series of actions – a discipline that can be used even if circumstances change. There are numerous stories about golfer Lee Trevino who would win games using such unconventional clubs as a coke bottle tied to a stick. His opponents, not knowing that he had developed a process, would be sure that no good outcome was ever possible using that type of equipment. He trusted that his process would work in the long run.

"Victory belongs to the persevering"
– Napoleon Bonaparte

Developing an investment process is hard work. It requires much thought and involvement. As a result, many investors never make the effort. Instead they find it easier to follow the “siren’s song” of Wall Street investment products. These products are created and sold to satisfy investor cravings for achieving desired outcomes. Today you can buy index funds (the original “outcome” investment) in the form of ETFs, baskets or “SPDRS”. You can buy index funds for the S&P 500, the Russell 1000, or the Wilshire 5000. You can specify commodity funds, energy funds, or “sin” funds (which contain alcohol and tobacco stocks). Many golfers will spend $500 on a single new driver that purportedly adds more distance or cures their slice (outcome). Instead, they could spend half that amount on a few lessons which would help them correct their swing flaws and allow them to use all their existing clubs better (process). Inevitably, the new club fails to produce the desired outcome often enough and is replaced with an even newer, “better” one, as happens with all the failed investment products. Unfortunately, it is easier to hide several unused drivers in the closet (or sell them), than figure out what to do with a collection of unwanted investment products that are often illiquid.

“I can tell you what I think will happen, I just can’t tell you when.”

– Phillip Fisher

The greatest enemy of the investor who concentrates on the outcome over the process is time. A process investor ignores time because he can’t control it and knows it is often uncorrelated to the outcome. The outcome investor also realizes he can’t control time, yet the longer it takes to achieve a positive outcome, the more he begins to question the merits of the investment. The result is that in an uncooperative market outcome, investors hop from one investment to another, usually chasing good past outcomes. They never know if those good past outcomes were the result of skill or luck.

“The first requisite of success is the ability to apply your physical and mental energies to one problem without growing weary.”

– Thomas Edison

I realize that some investors first response to the idea of ignoring time is that they “don’t have enough time left to wait” for an investment to pan out. Again, this is because outcome investors don’t understand that positive outcomes are correlated to a good process and uncorrelated to any specific time frame. The real problem is not a lack of time but that investors grow weary.

In summary, professional golfers focus on their swing (process), not on where the ball goes (outcome). They understand that a successful career depends on a good swing. Likewise, investors should focus on their swing - the investment process. If your process is correct, inevitably, and in time, more and more of your shots will end up in the middle of the fairway.

“For the things we have to learn before we can do them, we learn by doing them”

– Aristotle

AUDI PARTEM ALTERAM

Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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