Bill Sharpe and Hank Aaron

If we define being "right" or "wrong" as outperforming or underperforming the market, respectively, then in order to be right or wrong, we basically need to hold something different (either securities or bet sizes) than the "market". Bill Sharpe taught us that over two decades ago.[1] That's just math. Outperforming, very simply, requires deviating from the norm. In other words, it requires risk-taking. And there are two sides to the "risk-taking" proposition. On one side, there are gains; on the other, losses. The existence of one requires the possibility of the other.

If we start off with a random-walk base case, then in order to tilt the risk/reward equation in our favour demands a process or informational edge. Our specific approach requires the gathering of relevant fundamental information about specific companies (and the simultaneous dismissal of irrelevant information), the unbiased interpretation of that data in a sector context, rigorous modelling of those fundamentals, and then an identification of decision-making biases currently preventing the consensus investor from digesting the same data and arriving at our view.

That's pretty much it, and we think and hope that this moves us off the random-walk base case toward something more in our favour. Being 65% correct over time across the portfolio, for example, might be something that an investor should strive for. Of course you might even strive for even higher accuracy, but at 65% you very well may generate more than satisfactory long-term excess returns. But here is the toughest pill to swallow in that equation:

"If you want to be 65% right, you implicitly also want to be 35% wrong."

That coulda been a double play.

Of course you would like to make money in every single individual investment you make. Yet you must not only realize that you are taking risk, and that risk begets reward, but accept that risk when it is presented. This is one of the hardest lessons any of us can learn, and frankly, I am still in the process of learning it myself. When that loser reveals itself, I sometimes need to remind myself of Henry Aaron. "Hammerin' Hank" hit 755 home runs, eclipsing Babe Ruth's 714, but he is also third on the all-time list for grounding into double plays. With a runner on first, Hank went to the plate expecting the possibility of one or the other. If he truly never wanted a remote chance of grounding into a double play, he never would have hit a home run. Instead, he wanted a chance to ground out, embraced the risk/reward, and with that mentality, over a long and successful career, he hit over twice as many home runs as groundouts into double plays.

Staying within the baseball metaphor, whether you can hit .500, .600, or even .700, it will still take the aggregation of many seasons where we perform above or below our long term batting average before that average is revealed. During this journey, you should hope to see more wins than losses, and more doubles than strikeouts. You'll almost certainly also ground into some double plays too, and you may even hit a few grand slams. To find these home runs, stand-up triples, or bunt singles, our view is that identifying favourable risk and reward equations for individual securities requires one to do things differently than everyone else does. It gets back to doing things in a way that you think is better, but that your competition hasn't yet adopted. It gets back to being simultaneously unconventional and smart, and a willingness to look unconventional and stupid.

[1] *The Arithmetic of Active Management, William F. Sharpe, Financial Analysts Journal, January/February 1991, Vol. 47, No. 1: 7-9*