CHAPTER 1

THE LOSER'S GAME

DISAGREEABLE DATA ARE STREAMING STEADILY OUT OF THE computers of performance measurement firms. Over and over again these facts and figures inform us that most mutual funds are failing to "perform" or beat the market. The same grim reality confronts institutional transfers such as pension and endowment funds. Occasional periods of above-average results raise expectations that are soon dashed as false hopes. Contrary to their often-articulated goal of outperforming the market averages, investment managers are not beating the market; the market is beating them.

Faced with information that contradicts what they believe, people tend to respond in one of two ways. Some ignore the new knowledge and hold to their former beliefs. Others accept the validity of the new information, factor it into their perception of reality, and put it to use. Most investment managers and most individual investors, being in a sustained state of denial, are holding onto a set of romantic beliefs developed in a long-gone era of different markets. Their romantic views of "investment opportunity" are repeatedly proving to be costly.

Investment management, as traditionally practiced, is based on a single core belief: Investors *can* beat the market and superior managers *will* beat the market. That optimistic expectation was reasonable 50 years ago, but not today. Times have changed the markets so much that that premise has proven unrealistic: In round numbers, over one year 60 percent of mutual funds underperform (see Figures 1.1 and 1.2); over 10 years 70 percent underperform, and over 20 years about 80 percent underperform their chosen benchmarks.

If the premise that it is feasible to outperform the market were true, then deciding *how* to go about achieving success would be a matter of straightforward logic.

Figure 1.1 Total market versus Wilshire 5000 Index

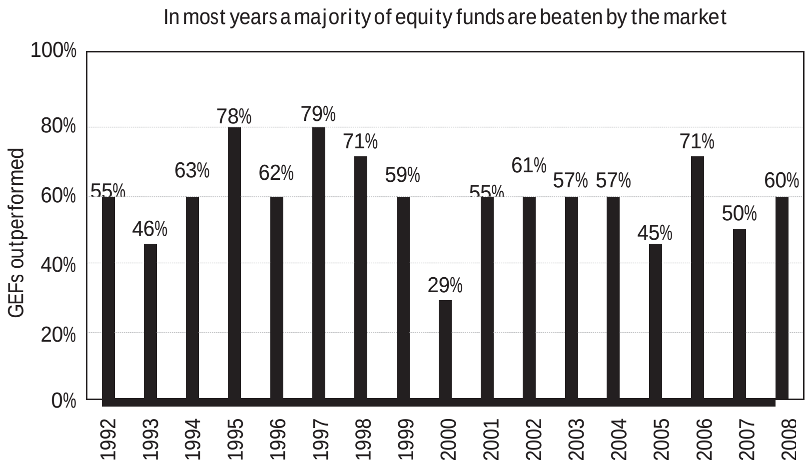
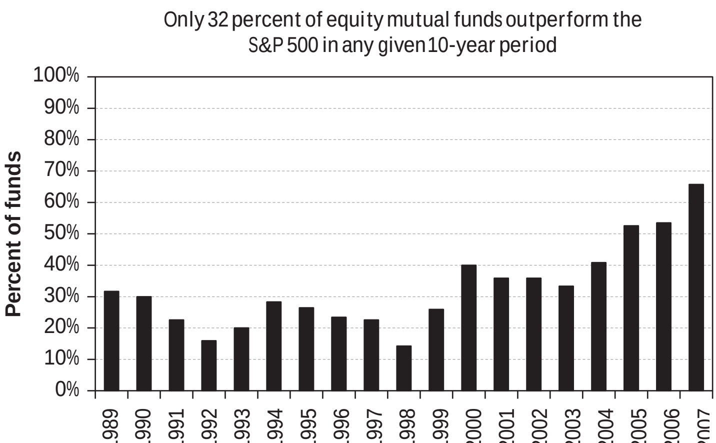


Figure 1.2



First, since the overall market can be represented by a public listing such as the Wilshire 5000 Total Market Index, a successful manager would only need to rearrange his or her portfolios more productively than the "mindless" index. The manager could differ from the market (his or her chosen benchmark) in stock selection, strategic emphasis on particular groups of stocks, market timing, or various combinations of these decisions.

Second, since an active manager would want to make as many "right" decisions as possible, he or she would assemble a group of bright, well-educated, highly motivated, hardworking professionals whose collective purpose would be to identify underpriced securities to buy and overpriced securities to sell—and beat the market by shrewdly betting against the crowd.

Unhappily, the basic assumption that most institutional investors can outperform the market is false. Today, the institutions *are* the market. Institutions do over 95 percent of all exchange trades and an even higher percentage of off-board and derivatives trades. It is precisely because investing institutions are so numerous and capable and determined to do well for their clients that investment management has become a *loser's* game. Talented and hardworking as they are, professional investors cannot, as a group, outperform themselves. In fact, given the costs of active management—fees, commissions, market impact, and so forth—investment managers have and will continue to underperform the overall market.

Individual investors investing on their own do even worse—on average, much worse. (Day trading is the worst of all: a sucker's game. Don't do it—ever.)

Before analyzing what happened to convert institutional investing from a winner's game into a loser's game, consider the profound difference between two kinds of games. In a winner's game, the outcome is determined by the correct actions of the *winner*. In a loser's game, the outcome is determined by mistakes made by the *loser*.

Dr. Simon Ramo, a scientist and one of the founders of TRW Inc., identified the crucial difference between a winner's game and a loser's game in an excellent book on game strategy, *Extraordinary Tennis for the Ordinary Tennis Player*.[1] Over many years Dr. Ramo observed that tennis is not one game but two: one played by professionals and a very few gifted amateurs, the other played by all the rest of us.

Although players in both games use the same equipment, dress, rules, and scoring, and both conform to the same etiquette and customs, they play two very different games. After extensive statistical analysis, Ramo summed it up this way: Professionals *win* points; amateurs *lose* points.

In expert tennis the ultimate outcome is determined by the actions of the *winner*. Professional tennis players hit the ball hard with laserlike precision through long and often exciting rallies until one player is able to drive the ball just out of reach or force the other player to make an error. These splendid players seldom make mistakes.

Amateur tennis, Ramo found, is almost entirely different. Amateurs seldom beat their opponents. Instead they beat themselves. The actual outcome is determined by the *loser*. Here's how: Brilliant shots, long and exciting rallies, and seemingly miraculous recoveries are few and far between. The ball is all too often hit into the net or out of bounds, and double faults at service are not uncommon. Instead of trying to add power to our serve or hit closer to the line to win, we should concentrate on consistently getting the ball back so the other player has "every opportunity" to make mistakes. The victor in this game of tennis gets a higher score *because the opponent is losing even more points.*

As a scientist and statistician, to test his hypothesis Dr. Ramo gathered data in a clever way. Instead of keeping conventional game scores—15 love, 15 all, 30–15, etc.—Ramo simply counted points *won* versus points *lost*. He found that in expert tennis about 80 percent of the points are *won*, whereas in amateur tennis about 80 percent of the points are *lost*.

The two games are fundamental opposites. Professional tennis is a winner's game: The outcome is determined by the actions of the winner. Amateur tennis is a loser's game: The outcome is determined by the actions of the loser, who defeats himself or herself.

The distinguished military historian Admiral Samuel Eliot Morison made a similar central point in his thoughtful treatise *Strategy and Compromise*: "In warfare, mistakes are inevitable. Military decisions are based on estimates of the enemy's strengths and intentions that are usually faulty, and on intelligence that is never complete and often misleading. Other things being equal," concludes Morison, "the side that makes the fewest strategic errors wins the war."[2]

War is the ultimate loser's game. Amateur golf is another. Tommy Armour, in his book *How to Play Your Best Golf All the Time*[3], says: "The best way to win is by making fewer bad shots." This is an observation with which all weekend golfers would concur.

There are many other loser's games. Like institutional investing, some were once winner's games but have changed into loser's games with the passage of time. For example, 90 years ago only very brave, athletic, strong-willed young people with good eyesight had the nerve to try flying an airplane. In those glorious days, flying was a winner's game. But times have changed, and so has flying. If the pilot of your 747 came aboard today wearing a 50-mission hat and a long white silk scarf around his or her neck, you'd get off. Such people no longer belong in airplanes because flying today is a loser's game with one simple rule: Don't make *any* mistakes.

Often, winner's games self-destruct because they attract too many players, all of whom want to win. (That's why gold rushes finish ugly.) The "money game" we still call investment management has evolved in recent decades from a winner's game to a loser's game because a basic change has occurred in the investment environment: The market came to be dominated by investment managers striving to win by outperforming the market. No longer is the active investment manager competing with overly cautious custodians or overly confident amateurs who are out of touch with the fast-moving market. Now he or she competes with hundreds and thousands of other hardworking investment experts in a loser's game where the secret to "winning" is to lose less than the others lose. The central problem is clear! As a group, professional investment managers are so good that they make it nearly impossible for any one professional to outperform the market—the expert consensus they together now dominate.

Today's money game includes a formidable group of competitors. Several thousand institutional investors—hedge funds, mutual funds, pension funds, and others—operate in the market all day, every day, in the most intensely competitive way. Among the 50 largest and most active institutions, even the smallest spends $100 million in a typical year buying services from the leading broker-dealers in New York, London, Frankfurt, Tokyo, Hong Kong, and Singapore. Understandably, these formidable competitors always get the "first call" with important new insights. (The SEL requires companies to make every effort to be sure all investors get all information at the same time.) Thus, almost every time individual investors buy or sell, the "other fellow" they trade with is one of those giant professionals, with all their experience, all their information, and all their computers and analytical resources.

And what tough professionals they are! Top of their class in college and at graduate school, they are "the best and the brightest"—disciplined and rational, supplied with extraordinary information by thousands of analysts who are highly motivated, hardworking, and very competitive—and all are playing to *win.* Sure, professionals make errors and mistakes, but the other pros are always looking for any error so they can pounce on it. Important new investment opportunities simply don't come along all that often, and the few that do certainly don't stay undiscovered for long. (Regression to the mean, the tendency for behavior to move toward "normal" or average, is a persistently powerful phenomenon in physics and sociology *and* investing.) Yes, several funds beat the market in any particular year and some in any decade, but scrutiny of the long- term records reveals that very few funds beat the market averages over the long haul—and nobody has yet figured out how to tell in advance which funds will do it.

The key question under the new rules of the game is this: How much better must the active mutual fund investment manager be to *at least* recover the costs of active management? The answer is daunting. If we assume 80 percent portfolio turnover (implying that the fund manager holds a typical stock for 14 months, which is slightly longer than average for the mutual fund industry) and we assume total trading costs (commissions plus the impact of big trades on market prices) of 1 percent to buy and 1 percent to sell (again, average rates), plus 1.25 percent in mutual fund fees and expenses, the typical fund's operating costs are 3.25 percent per year.[4]

An active manager must overcome the drag of about 3.25 percent in annual operating costs. If the fund manager is only to match the market's expected 7 percent future rate of return, he or she must return 10.25 percent *before* all those costs. In other words, to do merely as well as the market, an active fund manager must be able to outperform the market —the consensus of experts—in gross returns by over 46 percent![5] Achieving such superiority is virtually impossible in a market dominated by professional investors who are intensely competitive, extraordinarily well informed, and continuously looking for *any* opportunity.

That's why the stark reality is that most money managers and their clients ***have not*** been winning the money game. They have been losing. So the burden of proof is surely on the person who says, "I am a winner; I will win the money game."

For any one manager to outperform the other professionals, he or she must be so skillful and so quick that he or she can regularly *catch the other professionals making mistakes*—and systematically exploit those mistakes faster than can the other professionals. (Even the pros make *macro*-mistakes, particularly being fully invested together at market peaks, or choosing dot com stocks together. When they make *micro*-mistakes, they correct their errors quickly or see them exploited and quickly corrected by their professional competitors.)

The reason investing has become a loser's game for professionals is that their efforts to beat the market are no longer the most important part of the solution; they are now the most important part of the problem. As we learn in game theory, each player's strategy should incorporate understanding and anticipation of the strategies and behavior of other players. In the complex problem each investment manager is trying to solve, his or her efforts to find a solution *and* the efforts of the many determined competitors have become the dominant adverse variables facing active managers.

Working *efficiently,* as Peter Drucker so wisely explained, means knowing how to do things the right way, but working *effectively* means doing the right things. Since most investment managers will not beat the market, investors should at least consider investing in "index funds" that replicate the market and so *never* get beaten by the market. Indexing may not be fun or exciting, but it works, really with the data from the performance measurement firms show that index funds have outperformed most investment managers over long periods of time.

For most investors, the hardest part of "real life" investing is not figuring out the optimal investment policy; it is staying committed to sound investment policy through bull and bear markets and maintaining what Disraeli called "constancy to purpose." Sustaining a long-term focus at market highs *or* market lows is notoriously difficult. At either kind of market extreme, emotions are strongest when current market action appears most demanding of change and the apparent "facts" seem most compelling.

Being rational in an emotional environment is never easy. Holding onto a sound policy through thick and thin is both extraordinarily difficult *and* extraordinarily important work. This is why investors can benefit from developing and sticking with sound investment policies and practices. The cost of infidelity to your own commitments can be very high.

An investment counselor's proper professional priority is to help each client identify, understand, and commit consistently and continually to long-term investment objectives that are both realistic in the capital markets and appropriate to that particular investor's true objectives. Investment counseling helps investors choose the right objectives.

It's not active managers' fault that their results are so disappointing. The competitive environment within which they work has changed dramatically in 50 years from quite favorable to very adverse—and it keeps getting worse and worse because so many brilliant and hard-working people with extraordinary equipment and access to superb information keep joining in the competition.

Before examining the many powerful changes in the investment world, let's remind ourselves that active investing is, at the margin, *always* a negative-sum game. Trading investments among investors would by itself be a zero-sum game, except that the large costs of management fees and expenses plus commissions and market impact must be deducted. These costs total in the billions every year. Net result: Active investing is a seriously negative-sum game.

To achieve better than average results through active management, you must depend directly on exploiting the mistakes and blunders of others. Others must be acting as though they are *willing to lose* so that you can win after covering all your costs of operation. Back in the 1960s, when institutions did only 10 percent of the public trading and individual investors did 90 percent, large numbers of amateurs were realistically bound to lose to the professionals.

Even more discouraging to investors searching for superior active managers is the evidence that those managers who have had superior results in the *past* are not particularly likely to have superior results in the *future.* In investment performance, the past is *not* prologue except for the grim finding that those who have repetitively done badly are likely to stay in their slough of despair and not do well.

The one encouraging truth is that while most investors are doomed to lose if they play the loser's game of trying to beat the market, every investor can be a long-term winner. All you need to do to be a long-term winner is to concentrate on setting realistic long-term goals and staying the course with sensible investment policies that will achieve your own particular objectives *and* applying the self-discipline, patience, and fortitude required for persistent implementation. (Which is where index funds have so much advantage vs. active investing.) That's what this book is all about: redefining the investor's real objective and showing how each of us can enjoy playing a true winner's game.

Endnotes

1. Simon Ramo, *Extraordinary Tennis for the Ordinary Tennis Player* (New York: Crown Publishers, 1977).
2. Samuel Eliot Morison, *Strategy and Compromise* (New York: Little Brown, 1958).
3. Tommy Armour, *How to Play Your Best Golf All the Time* (New York: Simon & Schuster, 1971).
4. More than brokerage commissions and dealer spreads are properly included in transaction costs. The best way to show how high transactions costs are is to compare the theoretical results of a "paper" portfolio with the actual results of a "real money" portfolio. Experts will tell you that the differences are impressive. And there's yet another cost of transactions—the cost of unwisely getting into stocks you would not have purchased if you were not "sure" you could get out at any time because the market looked so liquid. This is the real liquidity trap. Think how differently people would behave on the highway or in the bedroom if they were sure they would be caught. It's the same way in investments: You don't always get caught, nor do you always *not* get caught. All these costs are part of the total transactions costs.
5. This makes the superior performance of Warren Buffett of Berkshire Hathaway and David Swensen of Yale all the more wonderful to behold