Chapter Four: *Execution and Icarus*

by Nathan Polackwich

Anyone who plays golf can sympathize with my problem. I have a great round going. All I have to do is bogey the last two holes and I'll break 80. I stand on the 17th tee, take a deep breath, and proceed to hook my drive directly into the woods. I limp home with two double bogeys and shoot 81. What happened?

There are few guarantees in investing, but I'll give you one: You will be wrong. The stock market has way too many moving parts to get it right all or even most of the time. Players of the Winner's Game must accept that perfection is unattainable.

But while you can't control the end result of an action, you can control its execution. The eminent sports psychologist, H.A. Dorfman, explained the importance of focusing on execution in his book, *The Mental ABCs of Pitching* (2000).[1] To Dorfman, "a pitcher is defined by the way the ball leaves his hand." Nothing else matters. All that should concern a pitcher is whether he delivers his pitches as intended. Good pitches hit out of the park are superior to bad pitches that go for strikes. Dorfman once asked Greg Maddux, one of the greatest pitchers of all time, how he did after a game. Maddux responded: "Fifty out of 73." Maddox meant that out of the 73 pitches he threw, he executed fifty as desired. The result of the game, the number of strikeouts and hits he gave up, was all irrelevant.

I now use Dorfman's approach when I play golf. Regardless of the shot I'm hitting or how I'm playing, I try to stay in the moment and think only about executing a fundamentally sound golf swing. Where the ball goes and my score are meaningless. So far my success at achieving this mindset has been "varied."

Dorfman's approach to evaluating pitching is precisely how investors should judge their results. When things go badly, which they will, you can't let your game-plan be affected. For instance, on my recommendation our firm once sold the stock of a company that, although its business had performed superbly, appeared extremely overvalued. Less than a week later a competitor came along and acquired the company at a price 20 percent above where we had just sold the stock. Inevitably, there was a lot of second-guessing among the analysts and portfolio managers at our next Investment Committee Meeting. Certainly, I was also irritated by the bad break, but for perspective, I read everyone the following quote by legendary investor Peter Lynch:

> Consistent winners…resign themselves to the fact that they'll occasionally be dealt three aces and bet the limit, only to lose to a hidden royal flush. They accept their fate and go on to the next hand, confident that their basic method will reward them over time. People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences. Calamitous drops do not scare them out of the game. If they've done the proper homework on H&R Block and bought the stock, and suddenly the government simplifies the tax code (an unlikely prospect, granted) and Block's business deteriorates, they accept the bad

[1] "Pitching With Purpose," New York Times

> break and start looking for the next stock. They realize the stock market is not pure science, and not like chess, where the superior position always wins.

I'm an investor. My goal is to buy and hold the most undervalued stocks I can find. When I deem a stock overvalued, I sell it. Sometimes I'm wrong, the company grows much faster than I expected, and the stock continues to rise. And sometimes, as Lynch notes, you can be right and *still* lose. In our case, a buyer emerged from nowhere to pay what in hindsight proved a remarkably imprudent price. These things happen, but I won't alter my strategy of selling stocks I think are overvalued.

What about when you get it right? Like Icarus the most dangerous time for an investor is when he's flying highest. In a bull market everyone looks and feels like a genius. Usually, the higher the paper profits, the more confident investors grow in their ability to predict the future. They take risks they normally wouldn't, exposing themselves to disaster. They might, for example, quit their day-jobs to trade Internet stocks.

Investors should always consider the possibility that success reflects luck rather than skill. Moreover, the greater the success, the greater the probability luck was involved. There is a very good chance, for instance, that an investor who doubles his money in a year when the overall stock market gains just 10% is taking a massive amount of probably unintentional risk. The odds are also high, then, that that investor will give back all of those gains and them some in subsequent years.

Epitomizing this premise was the Munder Internet Fund, which came into existence in July 1998 and whose ubiquitous advertisements on CNBC I still remember (back then it was called the Munder Net Net Fund). In the 20 months leading up to March of 2000 the fund price quintupled from $21 to $108. While the managers of the fund were undoubtedly smart marketers, were they also smart investors? Given that fund price had plummeted to $8 by September 2002, it's now clear that they were just lucky, beneficiaries of an unprecedented stock market boom in Internet stocks. As that cycle reverted to the mean, so too did their luck.

In *Fooled by Randomness* Nassim Taleb perfectly captured the essence of history's Munder Net Net Funds.

> [A]t any point in time the richest traders are often the worst traders. This, I will call the cross-sectional problem: At a given time in the market, the most successful traders are likely to be those that are best fit to the latest cycle…Worse, the best fit for a particular regime are fooled by randomness and grow overconfident…The black swan or rare event is inevitable for this trader.

Taleb coined the phrase, "Black Swan", to describe a large-impact, rare, unexpected event, which, paradoxically appears predictable with hindsight. The term stems from the discovery of black swans in Australia when that continent was first discovered. Until that time it was assumed that all swans were white. No one could have anticipated that there was some undiscovered continent inhabited by swans that weren't white.

Recent examples of black swans in the stock market include the 9/11 terrorist attacks, the crash of 1987, and, of course, the Internet bubble and its aftermath. Those fooled by randomness – suchas the managers of the Munder Net Net fund and presumably its investors – are particularly vulnerable to black swans. Their previous success deludes them into thinking they're bullet-proof, so they neglect to wear their vests.

To be clear, not all success comes from luck. My Dad would continually hit the lines when we played tennis, and his apparent "luck" use to drive me crazy. Was it luck? Sure, but because my Dad was such a good tennis player, the truth is that he was more likely to "luckily" hit the lines than me. Similarly, while getting a hole-in-one is unquestionably sheer chance for anyone, Tiger Woods has around 18 and I have none, which tells you something.