MONEYLIFE ADVISORY
MAS WEALTH

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How We Play the Loser's Game

Dear Fellow Investors,

This is my first letter to you. I hope to make this a quarterly communication and send it in the first week of each quarter. We got delayed this time because we were caught up in the rush of onboarding customers before SEBI regulations requiring a minimum investment of Rs50 lakh kicks in, which hasn't happened as yet.

Let me start my first letter by throwing more light on the process of selecting stocks at MAS. I have already mentioned a bit of this in the "Letter from CIO". If you haven't read it, you may like to download it from here. There is more to our investing process beyond that document, which I will try to explain through the quarterly letters.

The Loser's Game

This time, let us take a quick look at the work of Simon Ramo, who was an engineer at 16, a double PhD from Caltech at 23 and worked at General Electric and Hughes Aircraft. He formed two Fortune 500 companies and is the father of Intercontinental Missiles. He authored many books, including *Extraordinary Tennis for the Ordinary Tennis Player*. His important insight was that amateur tennis is a loser's game. The one, who loses fewer points, wins.

How did he know this, and what are the implications of his insight? Ramo was scientist, not a finance professional, and hence he adopted a scientific process to arrive at his conclusions. He did not depend on narratives, stories and gut feel to arrive.

The scientific process involves observation > hypothesis > testing > theory. Following this process, Ramo observed that tennis was actually two different games. Although players use the same rules and scoring, Ramo's extensive statistical analysis showed that the outcome of professional tennis is decided by the winners—80% of the points are won. On the other hand, outcome of amateur tennis is decided by the loser—80% of the points are lost. Professional tennis is a winner's game. Amateur tennis is a loser's game. What does it have to do with investing?

Investing is exactly like amateur tennis; those who make fewer mistakes, win. It may seem preposterous that I am comparing professional fund management, which draws the elite of the financial markets, to amateur tennis. But it is indeed so, and this has nothing to do with the talent and commitment of professional investors. The truth is, too much of the investment outcome depends on external factors which force us to make mistakes. After all, even a Federer will make gross mistakes if he is forced to play in blinding rain and snow.

For instance, investment result of buying a stock would depend on the price paid for it, how the company would perform and how other investors act on the stock. Only the first of these factors is in our hands. We have no control either or corporate performance or the market movement. So, where will we find our winners? You have to focus on losing less. And, I am not even talking about internal factors such as a wrong assessment of promoter capability, paying too high a price and the **dozens of mistakes induced by our right brain, which is fairly common among professionals**.

In short, we control much less of the investment outcome that we think.

This is not widely recognised, though. Professional investors are assumed to be skilled enough to hit winners, like professional tennis players. As a sidenote, you will be surprised to know how many different types of decision-making is a loser's game. Here is a quote from *Strategy & Compromise* by Samuel Morison, an American naval historian: "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 the side that makes the fewest errors wins the war." Also, interesting to note is that technology greatly helps us to reduce the errors in some loser's games, like flying.

First Elimination, Then selection

Most people focus on stock selection. But there is a step before that: elimination. As in sculpture, where the artist chips off the stone, to let the shape emerge, so too in stock selection, elimination is the key. To implement the insight of loser's game, we try to eliminate the sources of possible mistakes. The first source of potential loss is fishing in the wrong pond —the universe of stocks—which can cause a *permanent loss* of capital.

There are thousands of stocks listed on bourses. Most will never create much value. Price manipulation is rampant. We need to avoid poor quality stocks first. This is not simple. Even the best of investors are swayed by the idea finding diamonds in the rough or a frog turning into a prince. We hope we are not, ever.

We try to find stocks that fit all the parameters we think are important, such as growth, quality, stability etc. and are still be available at a reasonable valuation. Can these metrics be captured by stories, narratives, megatrends, turnarounds and speculative earnings outlook? No, all these metrics are numerical. Hence, we take a quantitative approach to stock selection. This means going strictly by quantitative filters to narrow the list of stocks. (Moneylife magazine was the first to use screeners in popular media.)

These filters help us to eliminate possible losers, allowing us to pick from a universe of stocks that have proven business models that create value—high profit margin, high asset turnover ratio, strong cash flows and high return on investment. If this is supplemented by low investments to grow the business, that would make it just perfect. Buying stocks from this universe sets us on a secure path. All that remains, then, is timing our entry and exit, where another sets of mistakes may happen. We have a quantitative guidelines for these two as well, to reduce errors.

We do hope that the result of this loser's approach will show up in your portfolio: solid businesses, some big long-term winners, low volatility and market-beating returns and most importantly, no stocks that give us sleepless nights.

A Very Happy New Year

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