

# BUSINESS & TECHNOLOGY

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## Luck trumps expertise in markets, author believes



MARK SUTCLIFFE

**P**icture a room with a hundred people standing in it. Everyone is asked to flip a coin. If it comes up tails, you sit. If it's heads, you toss again. In each successive round, everyone who flips tails is out.

Eventually, after maybe even 10 rounds, there might be one person left who has

never flipped tails. Would you consider that individual talented or just lucky?

That last person might feel special but, obviously, talent has nothing to do with a coin toss. But what if we were talking about something that seemed to involve skill, like picking the right stocks to invest in? Leonard Mlodinow would argue there's very little difference. Yet for a variety of reasons, human beings mistake luck for ability or merit. And it causes us to make bad decisions, including about our investments.

Mlodinow is the best-selling author of *The Drunk-*

*ard's Walk: How Randomness Rules Our Lives*. As an aside, he's likely the only person in the world who can say that he co-authored a book with Stephen Hawking and also wrote the script for an episode of *MacGyver*.

Mlodinow was in town this week at a presentation sponsored by a local investment firm, PWL Capital. What's an investment firm doing sponsoring a talk by a guy who disses most of the investment community? PWL doesn't take the approach of most firms. They favour an index-based strategy that doesn't try to beat the market.

When it comes to most of the investment industry, Mlodinow says they may look like they're using information, analysis and reason as the basis for their decisions. And some of them may appear to be quite good at it. But according to Mlodinow, their results are no better than if they were all just flipping coins.

Mlodinow showed a graph showing 800 mutual funds in order of their five-year performance. If you looked at their results over the next five years, there was absolutely no relationship to what they had done previ-

ously. In other words, when they say past performance is not necessarily an indicator of future performance, they should take out "necessarily."

Even if someone has a 15-year winning streak on the stock market — as Bill Miller of Legg Mason once did, prompting some headlines to describe him as the Greatest Money Manager Ever — Mlodinow is not impressed. Just based on the sheer number of players out there, the odds are pretty good that one of them will beat the market 15 years in a row.

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Along with trying to be too clever, we also mix up qualitative and quantitative information. And we mistakenly think very small numbers demonstrate something larger. We figure, for example, that the Ottawa Senators lacked some essential quality because they performed well — sometimes better than any other team — over the regular season but lost a seven-game playoff series. In fact, an 82-game season is a much better indicator of the calibre of a team than a short series.

And so what if the stock market has outperformed almost every other investment vehicle over an 82-year period? We see someone who outperformed the market for seven years and we think he's a genius.

## Sutcliffe: Human beings have biases, make mistakes

Just like if you have 10,000 people flipping coins, there's a good chance one of them will flip heads 15 times in a row.

Does that mean that there's no skill whatsoever involved in picking stocks? No. But if the performance of even the most skilled stock picker is no better over time than a random selection, what difference does it make? And, more importantly, how are you as a retail investor going to know which adviser has skill and which one luck?

The funny thing about human beings, Mlodinow points out, is that even when we think we're clear-minded, we have a lot of biases and make a lot of mistakes when we interpret data. We see patterns in a series of random events and think they prove something. Finding a cluster of cancer victims in one area, for example, doesn't by itself prove that the water or air is contaminated. A random event that occurs to one in five people won't distribute itself evenly across the country. There are likely to be clusters just by chance.

But those patterns cause us to make choices that may even be worse than relying on luck.

In one study he cites, a sequence of red and green lights is flashed. The red light flashes twice as often as the green one but otherwise there is no pattern to the sequence. After this becomes obvious, participants in the study are asked to predict the order going forward.

The smart thing to do would be to always guess red because you'd be right on two-thirds of your predictions. But most people try to guess the sequence of red and green and score lower than 67 per cent.

That's human nature.

We try to outsmart the safe bet and we lose. To Mlodinow, that's the difference between picking individual stocks and betting on the market by buying an index fund.

Now, do you want to trust your finances to someone who might perform no better than a series of guesses?

Can't decide what to do? Maybe you should just flip a coin.