The Roles of Skill and Chance

This article by MOI Global instructor Daniel Gladis is excerpted from a letter of Vltava Fund, a global equity investment fund launched by Daniel Gladis in 2004.

I have had a book of the famous Feynman Lectures on Physics on my nightstand for a long time. It is wonderful reading, although I must admit many things in the lectures are too difficult for me. One of the lighter lectures is entitled Probability, and in it Feynman tells about how people see patterns or designs even in entirely random phenomena.

Here is Feynman's example. Take a coin, which has a 50:50 probability that its tossing will result in heads or tails. Toss it 30× and record the number of heads. Repeat this entire experiment 100× and then consider the results. If there is a 50% probability in each toss that the coin will come up heads, we would expect that in each such 30-toss experiment the number of heads will approach 15. However, only 12 experiments resulted in exactly 15× heads. In 88 cases, the numbers of heads were different and ranged between 9 and 23.

If we continue tossing the coin on and on, however, the number of heads will in fact gradually approach one-half of all tosses, even though the probability that a head appears exactly 15× in 30 tosses is less than 15%.

The individual sequences of 30 tosses were also very interesting. Feynman shares the three following sequences:

TTHTHTHTTTTTTTTTHHHTTHTTHHTHTH – 11× heads, 19× tails, with tails 9× in a row

HTTTTHTTTTHTHTHHHTTTTHTTHTHTTH – 11× heads, 19× tails, with tails 8× in the first ten tosses

THTTHHHTHHTTHTTHHHTTHHTHTHHTHT – 16× heads, 14× tails, with neither side appearing more than three times in a row

These sequences may seem a little unusual, but if we know that the coin is fair, such that the probability of a toss resulting in heads is truly 50%, then we can admit that these results are within the confines of our expectations and that they may not be the result of any pattern or design. They are just common fluctuations entirely normal for this particular game.

Now let us consider, for example, that the first sequence represents returns achieved by a portfolio manager instead of coin tosses. Let us replace heads and tails with pluses and minuses, respectively. A plus represents a good period, and a minus represents a bad period. A good period may be one in which the portfolio manager's gain is positive in absolute terms or better than that of a comparable index, and a bad period may be one where the portfolio manager is in loss in absolute terms or performed more poorly than did a comparable index. That choice is up to the evaluator to decide.

This specific sequence of the portfolio manager's returns would thus look like the following:

– – + – + – + – – – – – – – – – + + + – – + – – + + – + – +

Nine bad periods in a row! Such a portfolio manager would probably be out of work for a long time, because his or her clients would have concluded that the manager's investment abilities are miserable.

Ha! In a coin toss, which is an activity where skill plays no role, tails appear 9× in a row and we consider it common fluctuation, whereas we regard an investor's nine bad periods to be automatic proof of incompetence. What if the role of chance is bigger than we think it is even here? Is there any way to know? We cannot successfully measure it precisely, although we may estimate it at least a little. Particularly important is to consider the length of the monitored periods. If they are nine weeks or nine months, then the role of chance will be so great as to render the results meaningless. I believe the same applies for nine quarters. But nine years? In that case, yes, an investor's skill will very probably dominate over random effects.

What exactly happened to David Einhorn?

An article with this title was published during May in Institutional Investor, and it inspired me to choose the topic of this letter to shareholders.

David Einhorn is one of my favourite investors. In 1996, he founded his company Greenlight Capital, and over the following 17 years he achieved an average return of 19.4% per year (source: Frederick Vanhaverbecke: Excess Returns, Harriman House, 2014.) This is an excellent result that ranks him among the best investors of the latest generation.

His results have been somewhat worse over the past four years. Judging by the returns of Greenlight Re, the returns of a portfolio managed by Einhorn were as follows:

2015: −20.2%
2016: +7.2%
2017: +1.5%
2018: −12.5% (January to April)

This is nothing horrific, but it is enough for some people to forget 17 years of excellent returns, for some investors to leave Greenlight, and for some authors, who usually cannot show any official investment history at all (not to mention any comparable to Einhorn's), to write articles referring to Einhorn as an investor who has lost his investment abilities (sometimes even using very indiscriminate language). But how representative are these most recent three years really? I think not very. As an example, let us look into history.

Graham's children

In 1984, at the occasion of the 50th anniversary of the publication of Security Analysis (by Graham and Dodd), Warren Buffett gave a legendary lecture at Columbia University, the content of which he later transcribed into the article The Superinvestors of Graham-and-Doddsville. Among other things, in the article he describes the returns of a group of investors who had close relationships with Benjamin Graham and whose investments followed in the footsteps of his value investing. They were the following investors or funds: Walter Schloss, Templeton Growth Fund, Warren Buffett, Sequoia Fund, Charles Munger, Windsor Fund, Pacific Partners, and Tweedy Browne.

What this group of investors had in common was not only a spiritual father (Graham) and value investing, but also greatly above-average returns. All significantly beat the US equity market. For the entire period of their activities evaluated, which ranged from 13 to 31 years among the individual managers, their average annual returns were between 13.9% and 32.9%, and their returns exceeded those of the index by 3.4 to 25.1 percentage points per year. What is extremely interesting is that every one of them – without exception – spent a considerable amount of time lagging behind the index. Buffett lagged behind in just 1 year out of 13, but the others' results were poorer than those of the index in approximately one-third of the years. **Let me repeat that: a group of legendary investors**

who substantially beat the indices, the returns of whom almost everyone would be more than pleased to claim as their own, had substantially below-average results one-third of the time. This sort of thing is the rule rather than the exception.

What do these findings mean?

1. It is possible to achieve substantially above-average returns over the long term, and investor skills are a decisive factor.

2. It is not possible to expect that above-average returns will be achieved in every short evaluation period. There, the role of chance is too large.

3. A value-based investment strategy does not bring above-average returns at all times and under all circumstances – and that is precisely the reason why it works over the long term.

4. Even the best investors spend a part of their careers on the lower rungs of the ladder.

All these points apply also to Vltava Fund. Over 9.5 years – that is the entire time the Fund has been applying its current investment philosophy – our returns have been 210 % higher than the returns of the comparable

MSCI World Equity index (our total return for this period is 346 % or 17 % p. a.). **Moreover, the Fund has done so with a portfolio that has much lower risk than that of the index.** If someone were to have asked me 9.5 years ago if this result would have been acceptable to me, I would not have hesitated for a second. Even despite this strong outperformance, there were several longer periods in this time when we were lagging behind the index. Chance certainly contributed to the overall result. Sometimes this was to our advantage, sometimes to our disadvantage, but its total influence is gradually diminishing with time.

Back to David Einhorn

Considering the above, I would certainly not be among those who would write off Einhorn. His results in recent years in no way slip beyond what can be expected. Moreover, I do not believe investment abilities can be lost. One can lose the ability to run, for example, but it does not work that way in investing. To the contrary, investors should get better and better with increasing experience and absorbed knowledge.

If we choose 20 people at random from a group of swimmers and let them swim for 400 meters, we can rank them according to their performance. If we let them swim the same distance of 400 metres the next day, their ranking will probably be completely the same. There, skill plays a decisive role. But when we select 20 investors and rank them by last year's returns, their ranking at the end of this year will probably be very different. Neither of these annual results will be very informative as to those managers' real investment abilities. We would need a much longer period to determine those.

In no case do I want to state that investing is a matter of chance. It certainly is not. Investing is a matter of probabilities, and those can be strongly skewed to the investor's advantage due to his or her abilities. What I am trying to explain is that every phenomenon contains a certain element of chance and that the human brain has a tendency to underestimate its influence. Our brains try to find order and cause even when these are not present, and that is a mistake. Chance plays its role also in investing, and it can produce seemingly unanticipated results in the short term. One should count on that. Nevertheless, the influence of chance is gradually reduced with the increasing length of the time series, and investor skill eventually comes to dominate. This period is certainly longer than several

quarters.

This is my reasoning behind my view on David Einhorn. A couple years of relatively poorer results tell us nothing about his investment abilities. The future will probably prove that these are still excellent, and his investors should instead consider adding to their investments in Greenlight Capital. Of course, all this is based on the assumption that David Einhorn does not let the superficial judgements of those around him get him down, and that he will continue in his business. Many successful portfolio managers have quit because they got tired of endlessly explaining their investment strategies and defending their methods, returned the money to their investors, and continue to manage just their own portfolios at peace and without stress.

I would not be surprised if Einhorn ran out of patience, and perhaps he should. It must be very frustrating for him to watch those around him judge him based solely upon short-term momentary returns and completely glossing over the fact that, for example, the net leverage of Greenlight Capital's portfolio (again according to statistics from Greenlight Re) has been only around 33% over the long term. Therefore, his strategy comes with greatly below-average market risk. Everyone is interested in returns but scarcely anyone asks about the risk a fund undertakes, even though these two things are inseparable from one another.

I am describing the case of David Einhorn in this letter because he is a well-known and much-followed investor. However, this entire situation can be generalised and used as a textbook case of how investors should orient themselves among funds. Decisions about whether they entrust someone with their money or not should not be based on whether a particular fund has had good or bad results over the past couple of years. It should instead be based on whether the investors understand the portfolio manager's investment philosophy and can identify with it. If they do not know it or have a problem with it, then they should not invest in the fund no matter how good the results have been. On the other hand, if they put in the work, understand the portfolio manager's investment philosophy, and like what they see, then this argument must through the long term prevail over any transient below-average performance of the fund that cannot be entirely avoided. This approach, however, requires a willingness to undertake certain effort necessary to understand the investment philosophy and it demands patience. Unfortunately, both of these are in rather scarce supply in the world of investing.

Frequency of statements

Investing is an activity that involves a great deal of subjectivity. It is highly dependent upon the questions one asks and the perspective and detachment with which one views things. A long-term manner of thinking is one of the key conditions for rational investing. This is something everyone should realize, even those who are now summarily condemning Einhorn. In this respect, I must admit my pride in feeling that Vltava Fund's investors share with me this opinion and long-term view. One of the bases for this feeling of mine is the fact that there are increasing numbers of questions from our shareholders as to whether it would not be sufficient to send out the Fund's performance results on a quarterly instead of monthly basis.

Our shareholders are apparently aware of the fact that movements of equities prices are altogether random in the very short term **but very well predictable over the long term**. This is, after all, the key to successful equity investing. In such an environment, it is desirable to completely ignore short-term results and focus solely on long-term goals. This is not easy, and so sometimes we must remind ourselves to do so.

We decided to accommodate these requests, and, starting from this month, you can request to change the frequency of statements to quarterly. The Fund's NAV will continue to be calculated once a month. Nothing will change about that. If you want to continue receiving your statements every month, you need not do anything. If you want to receive them on a quarterly basis, let us know (and of course you can switch back at any time). There is convincing evidence that the less an investor follows the development of his or her investments (within certain limits, of course), the better investment decisions he or she makes. Receiving statements at a longer frequency will reduce noise and increase the information value of those statements one does receive. Having said that, it is still my opinion (and consistent with the view expressed in this entire letter to shareholders) that even one quarter is too short a time for drawing any conclusions.

Changes in the portfolio

There was no reason to make substantial interventions into the portfolio composition during the past quarter. The companies in our portfolio have been showing very good profits, which is something you can easily verify by yourself. This year they have been performing perhaps the best ever in several recent years. If you get the impression that this is not much reflected in their share prices, I agree with you. Such periods are relatively common. This is not the first time we have been in such situation, and certainly it will not be the last. Sooner or later, however, the share prices will follow the development of their underlying value, just as they have in all previous cases. **That is one of the few things one can rely upon in investing.**

On behalf of the entire Vltava Fund team, I would like to thank you for your participation in the recent Shareholders Meeting. Attendance was record-breaking, and the almost family-like atmosphere surpassed that of all 13 previous annual meetings. We very much appreciate the opportunity to work together with a group of such pleasant and similarly thinking shareholders. It is a great honour for us. We thank you and wish you a lovely summer.

investments are not audited, are stated in approximate amounts, and may include dividends and options.