

# How Investing Imitates the World Series

Baseball season is upon us again. Like few other sports, baseball has achieved a mythical status in the minds of many. One can hardly read the sports page, or the opinion page, for that matter, without running into a “baseball as a metaphor for life” meditation. We will restrict our meditations to baseball as a metaphor for investing.

In 2003, Michael Lewis, a former bond broker at Salomon Brothers, published *Moneyball*, a study of the battle between traditional baseball management and a more scientific, statistically based approach. It may seem odd that the author of a book on baseball should come from the investment world, but the applicability of the conflict in the book to investing is quite clear. The thesis of *Moneyball* is that traditional baseball wisdom is misguided, placing too much emphasis on subjective rules of behavior that have no connection to the realities of winning baseball games. By analyzing what actually works, using modern computer power and statistics, teams can improve their performance.

The financial markets are also laden with traditional rules and “wisdom” that have little basis in reality. We hear endless speculation of the future actions of the Federal Reserve, for example, but has that ever made you money? Business reports are full of noise relating the economy to potential stock market movements, without a scintilla of historical evidence that this kind of analysis actually works. Most major investment firms, though, have staff economists. If potential clients think it is important, it is important to persist in the illusion; the illusion has become the reality if you are trying to sell a product.

Much of Lewis’s book involves the hostility from baseball traditionalists towards the new analytical methods. Teams adopting the new methods, however, have been successful. The Oakland Athletics consistently make the postseason despite having one of the smallest payrolls in the major leagues. The Boston Red Sox, two years after adopting the

new approach, won their first World Series in 86 years. Still, most in the game persist in following tradition.

Lewis found that traditional baseball managers and scouts rely too much on their own experience, what they have personally seen, rather than looking at the world outside their experience. They extrapolate recent experience, believing, for example, that a hitter's hot streak means he suddenly is a potential all-star rather than temporarily lucky. They are too likely to follow old rules of thumb rather than confront evidence of reality. Many investors suffer from the same maladies. For example, value stocks have performed better than growth stocks over long periods, but a growing, successful company, however richly priced, is more compelling to investors than a story about a troubled company that may be selling too cheap.

*“Many people think they are smarter than others in the stock market and that the market itself has no intrinsic intelligence.... Actual data from the market means more than individual perception/belief.*

**- John Henry, owner,  
Boston Red Sox**

In baseball, if there is a runner on first base with no outs, the traditional rule is to have the next batter sacrifice bunt to advance the runner to second. Statistics show, however, the potential run production from a runner on first with no outs is higher than having a runner on second with one out. In most situations, therefore, the sacrifice bunt makes little sense. Why does the

tradition persist? In baseball as on Wall Street, admission to the managerial ranks usually results from following tradition, the institutionalized beliefs and rules. To fail conventionally is bad, but you retain membership in the comfortable “club.” Failing unconventionally brings the risk of ostracism. Therefore, curiosity about new methods is not encouraged.

In both baseball and investing, luck dominates short-term outcomes. Lewis quotes an estimate that the impact of superior skill in baseball is one run per game, while the impact of luck is four runs per game. Luck goes both ways, though, while superior skill is always positive. Over the course of a baseball season, skill tends to win out, but it is hard to discern in the short run. A great hitter might get one more hit every two weeks than a mediocre hitter, hard to detect through observation. Most successful investing strategies similarly acknowledge the dominance of chance over short periods; in any given year, an aggressively unskilled manager might still lead the performance charts. The key is to have a successful process. Luck dominates short-term outcomes, but a superior process should ultimately triumph.

It is no accident that one of the first baseball team owners to adopt the techniques described in *Moneyball* was a successful market trader. John Henry, despite no background in baseball, had an intuitive grasp of the keys to success. As in baseball, even misguided tradition has a great deal of persistence on Wall Street. Journalists laud every hot new manager as a genius, analysts pore over every meaningless economic statistic, reporters lay every squiggle in the market indexes at the feet of some “cause,” rather than luck or chance. If you would like advisers that emphasize a rigorous process in investing rather than chasing an illusion of certainty, call us at (503) 419-3938 or check [www.sigmainvestment.com](http://www.sigmainvestment.com). Do not sacrifice your retirement funds in the name of tradition