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No Country For Bold Men

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In Cormac McCarthy's novel *No Country for Old Men*, killer-for-hire Anton Chigurh gives some victims a chance to escape their fate by calling heads or tails on the flip of a coin. We all have made bets on the flip of a coin, so the excruciating suspense in the novel is not the result of the probabilities but from what is at stake. Psychology makes all the difference, and the amount at risk matters. Think of the gymnasts navigating the balance beam in the recent Olympics. Lay a plank of wood on your lawn and walk from one end to the next and there is no fear interfering with your balance. Suspend the same plank between two buildings 20 stories up and navigating it becomes more of a problem.

Imagine you have a coin that, when flipped, lands on heads 55 percent of the time. After an undisclosed number of flips, the coin disappears. How much of your net worth would you be willing to bet on the next flip of the coin, the next two flips, or four?

About every 25 sequences of four flips, you will experience four tails in a row. You have a definite advantage with the coin, about twice that of Caesar's Palace with their roulette wheel, but also a risk of ruin if you bet too much.

Time and other psychological circumstances also come into play. It is one thing to be flipping the coin repeatedly when you have immediate results. If you happen to flip tails, it is stupid to regard that as "failure" since it assuredly will happen about 45 percent of the time. Casino pit bosses do not suffer low self-esteem every time a lucky patron wins at roulette.

Now assume that, instead of the coin, you have an investment approach that, history tells you, succeeds 55 percent of the time over a one-year period. When the strategy does not work, there will be others with different approaches (perhaps even the opposite of yours) crowing about their success. In this context, it is much easier for you and others to look at your efforts as a failure.

When the strategy falls short in a second period, disappointment intensifies. When the strategy fails in a third year, you are likely to conclude it is not working and switch to one of the strategies that have been "working," even though they may be the equivalent of betting on tails with that special coin.

You never will capture your advantage in the long-run if you cannot pursue the strategy through the inevitable adverse short-runs. Of course, in real world investing there always will be a nagging

doubt that your strategy actually has an advantage.

We all want to see things in absolutes, with sure wins and losses, and we have a hard time processing slight advantages. Hence, most investment come-ons avoid probabilistic language. *Dow 36,000* or *The Coming Financial Crisis* - no sense of any doubt in those titles. The problem is that no sure things occur in investing.

Investing involves three steps: (1) figuring out something that can make you money (your edge); (2) allocating the appropriate amount of capital to that edge (bet sizing); and (3) having the fortitude to pursue the strategy (flipping the coin even when it comes up tails).

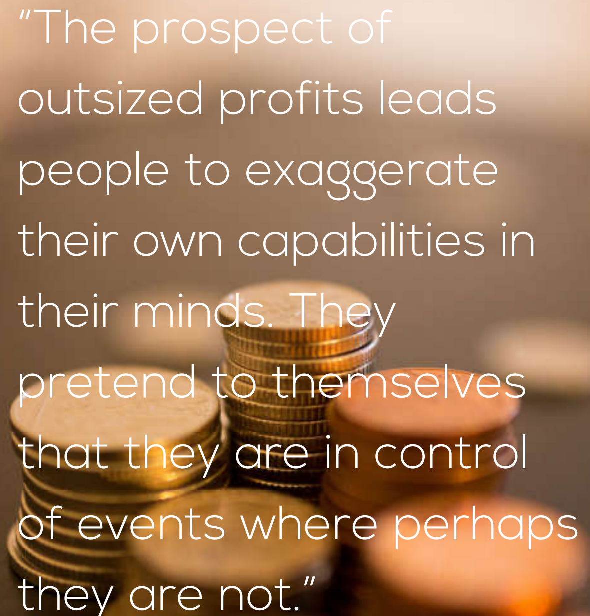
Falling short on any of the three virtually assures failure. You cannot choose not to play - even indexing investments is not a way out. Lower cost is an edge, but you still have to size your bets (deciding how much to invest in equities versus bonds, or domestic versus foreign investments) and you still have to struggle with human nature.

Proponents always assume, against evidence, that index investors faced the bragging from their in-laws about tech stocks in 1999 or their co-worker flipping houses in 2006 with equanimity.

Finance theory tells us that equities *should* enjoy a risk premium, with risky stocks out-performing less risky bonds, but long-term Treasury bonds have performed better than the S&P 500 Index over the past 10 and 20 years.

Troubled "value" stocks have a higher cost of capital and therefore *should* outperform growth stocks (since investors are suppliers of capital), but the so-called value premium is absent over the past decade.

Investors *should* value investments by discounting future cash flows back to the present using the risk free rate, but many government bonds (usually the proxy for the risk free rate) around the world sell at negative interest rates. All three examples are good bets, but in question by investors now.



The coin flips in McCarthy's novel show us that even mundane bets can be exciting.

The flip side (to coin a phrase) is that emotional thinking is destructive to investment returns. At Sigma, we realize the hard part is the knowledge of appropriate risk levels and the research allowing reasoned confidence to combat human nature.

Only then can you avoid feeling as if you are betting against Chigurh.