Mark's Musings

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> ***"In life [my] first job is this, to divide and distinguish things into two categories: externals I cannot control, but the choices I make with regard to them I do control. Where will I find good and bad? In me, in my choices."***
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> ***- Epictetus***

Meditations on the Role of Skill, Luck and Gambling as They Relate to Investing

I have at many points in my investing career been confronted by a similar question. Usually the context is where the individual posing the question has just endured unexpected losses in some particular investment. Variations of the question include, "Isn't all investing just luck?" Or, "Aren't investment professionals just making educated (or perhaps uneducated) guesses about what markets are going to do?" Or, "Isn't playing the stock market just like going to a casino?"

If I had to distill these variations to a single query, it would be, "So, is investing skill, luck or gambling?" The answer is simply, "Yes." Since most of us want to see things as black or white, and oftentimes dislike subtlety or nuance, particularly concerning a topic of such import – namely, what determines the very manner in which our net worth will grow (or not) – this may be a maddening answer. But let me proffer that investors who understand the nature in which skill, luck and gambling intermingle will stand to make much sounder decisions concerning their portfolios throughout the course of their lives.

Never Confuse Brains with a Bull Market

As anyone who has read many of my essays knows, I am a pretty harsh critic of the financial services industry (perhaps this is a form of self-loathing?). It is literally the only industry of which I am aware that actually *subtracts* economic value from the people who use it on such a vast scale. Despite the nearly *$200 billion* in net profits brought in by the financial services industry last year, research from the early 1970's onward by the likes of Burton Malkiel and John Bogle show that the financial services industry as a whole underperforms its benchmarks, and does so roughly in proportion to its fees. Why are more people not outraged by this phenomenon? I believe the answer lies in a form of money illusion.

The most basic example of this money illusion is where a worker gets a 4% raise and believes his overall position is improved even though prices are going up 5% a year. Most people do not properly adjust for movements in general price levels and are thus more likely to be satisfied simply when their absolute pay goes up. They fail to consider their relative position and as such, they do not recognize that they have become less well-off, not more, as the amount of goods and services they can purchase has diminished.

So how does something similar prevent investors from realizing the extent to which their brokers and money managers are failing them? I believe it is due to the general tailwind at the backs of stocks and bonds. Take the last sixty-five months. Let's say you invested money with a broker who has convinced you to invest in a basket of large cap US stocks he recommended. You largely forget about it and only now open up a statement indicating your money has more than doubled, netting 15% a year. I have no doubt that most retail investors would be thrilled with this result. Indeed, many, if not most, would be writing large additional checks to the broker, shifting more of their assets to whatever he said was attractive.

But a few thoughtful and observant investors would be outraged at the broker's terrible performance over such a long period of time. You see during that same time period the S&P 500 (a proxy for large cap US stocks) was up almost *three times*, meaning that the broker underperformed the index by a staggering 35+%!

Almost this exact situation occurred when a college friend asked me to look over her finances after a divorce. She had a friend – who worked for one of the largest financial institutions in the country as a wealth manager – directing her investments. I was stunned at the paltry returns generated in assets that were generally deployed in US stocks and bonds despite sensational (and unsustainable) equity returns over the last five years. Adding insult to injury, she was being charged almost 300 basis points a year in a variety of fees. To this financial institution's credit, they at least provided a column entitled "return versus benchmark" for each investment (all investors should demand such an accounting if they do not already do so from their financial services professionals). Not surprisingly, virtually every number was negative, and usually by a significant amount.

This is not to say there are not extremely skillful money managers out there (indeed, given our fund's fee structure, my very professional livelihood depends upon this being the case). So how does one find these people? I have a couple of thoughts. First, I suggest you find out what any potential money manager was suggesting people do at major turning points in the markets. For instance, most money managers were "all-in," with very little cash on the sidelines at the market peak in late 2007, while being largely out of the market in March 2009 when equity markets hit their nadir. Skillful managers should see danger and take steps to mitigate it well before it can devastate their clients' portfolios. Similarly, they should be picking up assets on the cheap when the sky has fallen and everyone else is running for cover. Far too many money managers hid behind the skirt of their industry as a whole when they had their clients heavily invested in risky assets and the 2008-09 crisis hit. While no one knew the precise time in which the house of cards would collapse, the signs of extreme peril were manifest to any financial professional who chose to ignore greed and self-interest. Second, measure money managers' *relative* performance against their peers, and do so over the *greatest time period* possible. While a municipal bond manager may have earned an annual return of 7% while the aforementioned broker earned 15% yearly over the same period of time, the municipal bond manager's relative performance against her peers would be vastly superior, since municipal bond returns have been much more muted. And crucially, as I have said many times before, in good times and bad, short-term performance should be given little weight.

When Bad Returns Happen to Good Managers

I am partial to meritocracy by nature. The idealistic side of me would like to think that successful people universally possess qualities such as diligence, virtue, resourcefulness, courage, reason and creativity. But the realist in me knows that more than a fair share of successful people were in the right place at the right time or simply knew the right person. More disturbingly, the reverse of this is also true; many otherwise talented, bright and determined people are beset by misfortune which stunts, or in some cases destroys, their careers.

It would be naïve indeed to believe that luck has no role in one's success as an investor. I can personally think of many instances where luck played a hand (somehow I seem to remember more of the bad variety as opposed to the good). For instance, retail foreign exchange platforms only became widely available at the turn of the millennium. I was thus able to open an account by the end of 2002, at a time when the US dol-

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lar was egregiously overvalued yet had only declined a little more than 10% from its peak. I simply remained short the US dollar on a fairly leveraged basis for years as it declined a total of almost 40%. Had it taken another five years for currencies to reach retail investors, I would have missed out on one of the most profitable investments I have ever had. Granted, this is probably an example of the adage, often attributed to Seneca (one of my favorite philosophers), that "luck is what happens when preparation meets opportunity."

On the flip side, March 11, 2011 was a dark day for Japan, as the Tohoku earthquake and tsunami would ultimately kill more than 15,000 people.[1] The tsunami in turn caused the Fukushima Daiichi nuclear disaster. There had not been a nuclear disaster in a major developed economy in over thirty years, and nuclear power was seen as safe enough that its use was expanding through much of Europe, the US, Japan and developing economies. On the eve of the disaster, I had invested heavily in uranium and uranium mining companies, being convinced that nuclear power represented a cost-efficient and relatively safe alternative to fossil fuels. Uranium oxide prices crashed more than 25% in the months following the disaster. The stock prices of uranium miners faired even worse, with several going down 33% almost immediately after the disaster. In sum, unforeseen and/or extremely unlikely exogenous events can have a *huge* role when it comes to the short-term returns in one's portfolio.

"… exogenous events can have a huge role when it comes to … short-term returns …"

But there is another, less appreciated, manner in which luck plays a hand when it comes to investing returns. Let's say you have two money managers plying their trade within the same asset class. The first is outstanding. On average he is able to beat his benchmark by 5% a year, such that a quarter of the time he exceeds the benchmark by 20%, a quarter of the time by 10%, a quarter of the time he meets the benchmark and a quarter of the time he underperforms the benchmark by 10%. I know that is overly simplified and is not representative of how a random distribution curve actually works, but this is just to illustrate a point. The other manager is awful, but as a result of being a great salesperson has obtained a critical mass of investors. On average, the second manager underperforms his benchmark by 5% a year, such that a quarter of the time he underperforms the benchmark by 20%, a quarter of the time by 10%, a quarter of the time he meets the benchmark and a quarter of the time he outperforms the benchmark by 10%. So any given year, the first manager would be expected to outperform the second manager by a significant margin of *10%*.

Ah, but this is where luck can alter the landscape significantly. One might expect that after three years the skillful manager would have returns exceeding the poor manager by a full 33%, and on average, that would be correct. But there is a greater than 1.5% chance that these two managers of greatly disparate skill would have the *same* returns. Now this could happen because the poor manager had exceptionally good luck and had returns that averaged 5% a year above the benchmark, this could be because the talented manager had exceptionally bad luck and averaged -5% below the benchmark annually, or it could be because the poor manager had moderately good luck while the skillful manager had moderately bad luck and they both simply equaled benchmark returns after three years.

Now a logical question might be, "If luck can have such a prominent role in investment returns, why bother?" The answer is time. You see, after five years, the odds that the two money managers of disparate skill would have equal returns is less than 1 in a thousand; after seven years, it is less than one in 16,000; and after ten years, it is less than one in a million. One of the reasons I waited nearly ten years after beginning to invest in currencies before launching the fund is that I was acutely aware that returns of three, or even five, years could

[1] CNN.

be distorted by unusual market conditions (luck) which may have made exceptional returns unrepresentative.

Investing is a lot like poker (I used to play semi-professionally). The shorter the duration one plays, the more luck plays a role. But the longer the duration, the more skill becomes the determining factor of success. You can have the best poker player in the world play head's up with someone who just learned the game. After five hands there is an excellent chance the novice would be ahead, through sheer luck of the draw. After fifty hands, this would be far less likely, and after 5,000 hands, virtually inconceivable.

The key takeaway, then, is not to give an inordinate amount of significance to very good or very bad short-term returns when it comes to investing, as luck may play a disproportionate role.

Be the House

Having brought up poker, I could not ask for a better segue into the concept of investing as gambling. I would contend that investing is more like gambling than perhaps any other analog. Now before fund investors scramble to find redemption papers, let me explain this statement, which on its face may seem audacious.

Gambling gets a bad rap. Most of us probably think of the millions of people who flock each year to Vegas - sheep about to be sheered by the multi-billion dollar casino industry. Or worse still, the image of the unemployed individual driving to a local casino futilely trying to parlay a couple hundred dollars into a big win may come to mind. While both of these scenarios are instances in which participants have negative expected returns, other forms of gambling are both quite rational and potentially profitable.

Gambling is broadly defined as *engaging in an activity in which there is a risk of losing money by betting on an uncertain outcome.* Importantly, every time someone sits down alone at a blackjack table and places a bet, there is not just one party gambling. The counterparty, the "house," is also betting on an uncertain outcome in which it can lose money. The only difference between these two parties is the *odds required for each of them to risk their capital*. The casino never places a bet, or more properly never allows itself to take a bet, unless it has a better than 50% chance of winning.

An example of highly rational "gambling" (with significant expectation for profit) is an instance in which someone bets you $20, even money, that he will roll two ones with dice. The outcome is uncertain, and you risk losing $20. Yet 35 out of 36 times on average you will win, making your expected profit almost $19, or roughly a 95% rate of return on the $20 at risk! Similarly, if someone offered to flip a coin that was weighted to land on head's 60% of the time, I would gladly wager $1,000 that it will land on heads, and would continue to do so *ad infinitum*. Obviously this would not be a wager without significant risk. While very, very unlikely, it is not inconceivable that I could be $10,000 in the hole after ten flips (the odds would be about 1 in 9,500). But the odds I would be down $20,000 after twenty flips are less than 1 in 90,000,000. Conversely, every time the coin is flipped, I have an expected profit of $100. And it is mathematically inconceivable that after 100,000 flips I would not be substantially in the black, with an expected profit of a cool $10,000,000. Now, if I could only find someone to take the other side of the bet…

"Investing is a lot like poker. The shorter the duration … the more luck plays a role."

Investing is exactly like gambling in that every investment of any significant duration is indeed a "bet" on an uncertain outcome. I can already hear the protests, "What about my investments in government bonds with a fixed rate of return? There is nothing uncertain about that, is there?" Two points to consider. First, while the interest, or "coupon," may be fixed each year, the value of the underlying instrument is not. During periods of high inflation and/or interest rate hikes, like the 1970's, the price of longer-term bonds has dramatically decreased. So you may have a bond that pays 4% interest, while the underlying security plummets in value by double digits in a single year.

The second point is that even if one has a guaranteed rate of return, this does not insure a guaranteed level of *purchasing power* in the coming years, thereby making the risk of a material loss in one's standard of living quite significant. Let's say that a very financially conservative, affluent retiree decides to put all of his money into thirty-year treasury bonds, believing them the safest investment on the planet. While the yield is paltry (roughly 3.25%), he wants no risk to the principal. Furthermore, since inflation has averaged 1.6% over the last five years, our retiree is confident he can live frugally on the interest generated each year.

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While we have indeed had halcyon days in terms of low inflation for quite some time now, history shows this can change rather dramatically. For fifteen years between the early-1950's and mid-1960's, US inflation averaged a scant 1.5%. It then doubled over the next two years. It then more than tripled from its base rate in the two years after that to the high 4% range. By 1974, not ten years after the period of virtually no inflation, prices were increasing by 11% a year. In such an environment, our previously complacent retiree would be losing more than 9% in purchasing power a year (factoring in his planned draw downs). After a decade, the portfolio would be down 55% in *real* (inflation-adjusted) terms.[2]

The point is this: any one of us who are interested in increasing our asset base over the course of the coming years may not *want* to "gamble," as none of us like the prospect of potentially losing money or purchasing power, but we are *forced* to do so in light of an inherently uncertain future. As such, the most rational thing to do is to be the best gambler possible (or employ as money managers such people). Thus it may not be surprising that the most important hallmark of a great gambler is the same thing that determines the greatest investors in the world – *superior risk-reward analysis*. In other words, they are like the house in Vegas, only placing "bets" when they believe they have the odds in their favor.

I maintain that it is impossible to be a "great" craps player. Rather, one could only hope to be a "less bad" craps player. Why? Because no matter how you optimize your strategy to have the very best odds possible during any given session, *your expected value is still negative*, albeit less negative than your fellow gambler who might be prone to wager on the "sucker bets" by trying to predict an exact throw of the dice. A superior gambler/investor only makes a bet/takes a position when he perceives there is a positive expected value. The higher the risk, the greater the expected rate of return must be to justify "gambling."

One obvious manner in which gambling is perfectly analogous to investing is that the house always wins. Financial institutions, like casinos, earn great profits by separating people from their money. No matter what happens in the market, they "win" by earning fees off their clients' hard-earned dollars. These fees can be quite onerous (especially if/when market returns become muted). Perspicacious investors can combat this by insuring that all of their investments have fees that are competitive given the specific financial product in question. This is especially important for individuals who employ wealth managers. Many such managers are simply "shadow-indexers." Their goal is merely to obtain market returns for their clients in a variety of asset classes. The problem is that few wealth managers charge fees commensurate with simply assembling a portfolio of index funds or exchange traded funds (ETFs).

I should note that one very important manner in which investing is *not* like gambling relates to losses. There is an old adage that "dice have no memory." Someone

[2] While it is outside the scope of this discussion, in light of the unprecedented monetary expansion undertaken by the Fed as well as the untenable fiscal position in which the US finds itself, I believe the chances of a significant increase in the rate of inflation in the coming years is much higher than what is priced into the markets.

who is naïve in their understanding of statistics may believe that their odds of rolling two ones a third time after having done so two consecutive times already is 1 in 46,656 (the odds of making such a roll three times in a row). But of course it is still 1 in 36. This kind of naiveté may lead the irrational and unskilled gambler to press when losing, increasing bet sizes with the mistaken belief that his past bad luck means it is more likely he will imminently have his share of good luck.

But investing is altogether different, which is why dollar-cost averaging can be one of the most profitable strategies. It is also one of the reasons why some of the best investors in the world have seen spectacular gains come only after enduring losses. Market history demonstrates that investors with sound strategies are rewarded more handsomely when adding to losing positions than they are when chasing winners. Whether it is investing in US stocks at the end of 2008 (well into the crash, but before the market finally bottomed in March 2009) as opposed to 2007 when everyone else was piling in, purchasing gold at the turn of the millennium when it was around $300 an ounce before it bottomed around $250, or going long the yen in the middle of 2006 (a full year before it would bottom, only to increase 35% from its lows in the following years), investors with sound investment theses and conviction are best served by taking proportionally larger positions as assets become cheaper.

Investing is a complex interplay of skill, luck (particularly in the short-term) and gambling. Superior investors are able to appreciate this intricate interaction. While it is challenging at times, not letting setbacks along the way (particularly those that primarily have at their source market fluctuations) derail them from implementing sound strategies is paramount to success. Indeed, taking *advantage* of those setbacks has distinguished the very greatest of investors (e.g. John Rockefeller, Sir John Templeton, Warren Buffet and Jim Rogers). Great investing is where depth of insight is combined with sound strategies and the courage to maintain one's convictions in the face of near-term setbacks.

"… taking advantage of … setbacks has distinguished the very greatest of investors."

*** Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.**

Q2 2014 Performance Summary

Second quarter 2014 results for Whitmore Capital L.P., net of all fees, were a very disappointing -9.68%.[1] By way of comparison, during the second quarter the BarclayHedge Currency Traders Index returned -0.52% while the Credit Suisse Hedge Fund Index was up 1.89%.[2,3]

The principal reason for the poor performance in 2Q 2014 is the fund's continued bias toward defensive, or "risk off"[4] currencies. We continue to maintain the strong belief that the risk-reward profile for traditional assets, particularly US stocks, is unfavorable and have positioned the fund accordingly. Needless to say, our expectations were not borne out in the second quarter, as US equity markets continued their march upward – in some cases to all-time highs – and stock market volatility remained largely absent. Unfortunately the same lack of volatility was not present in currency markets. Two significant down months were broken up by one strong month in 2Q 2014.

At the level of individual investments, our short positions in the "risk on" New Zealand Dollar and British Pound accounted for a very large part of our underperformance. We view both currencies as being significantly overvalued (particularly the pound), and thus acutely vulnerable to a dislocation in the market. However, as investors remained complacent, both currencies appreciated over the quarter, making multi-year highs.

"While remaining rational … is often challenging in the face of significant capital losses … it is certainly better than the alternatives."

We remain steadfast in our global economic outlook, but as a result of this, we note that as long as complacency rules the day and financial assets remain at elevated values, fund-level returns will face a challenging headwind.

More broadly, we would like to emphasize that the fund has a long-term investment horizon. We certainly do not take periods of negative performance lightly, but our aim is to capture profit opportunities from long-term currency movements. Given our approach, we give far less credence to extreme quarterly, semi-annual and even annual results, whether positive or negative. Instead our goal is to deliver compelling, sustainable returns to investors over three-, five-, ten-year periods and beyond, and to judge ourselves and our strategy based on our ability to do so.

In the interim, we remember the axiom: Things that cannot go on forever will stop. And we continue to manage our investments to ensure to the best of our ability that the fund will be in a position to benefit

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[2] About the Credit Suisse Hedge Fund Index. This index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

[3] BarclayHedge Currency Traders Index returns are taken from a BarclayHedge flash estimate and may be subject to change. The BarclayHedge Currency Traders Index is an equal weighted composite of managed programs that trade currency futures and/or cash forwards in the inter bank market. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

[4] "Risk off" or defensive currencies are treated as "safe haven" currencies. These currencies tend to appreciate during periods of investor fear or general asset market declines.

from a reversal in trend, when it indeed does occur.

On a more personal note, times like these, when short-term returns are discouraging, make me think of John D. Rockefeller, the son of an alcoholic father who abandoned Rockefeller and his family, causing John to take his first job at the age of 16. Rockefeller possessed an exceptional ability to remain dispassionate and disciplined while economic chaos swirled about him. He rose to astounding economic prominence at a time in American history (the mid-1800's through the depths of the depression) in which the nation experienced arguably its biggest boom-bust cycles ever. As Ryan Holiday notes in his excellent (and short) book on stoicism, *The Obstacle is the Way*, Rockefeller understood that:

> *The market was inherently unpredictable and often vicious – only the rational and disciplined mind could hope to profit from it. . . . [He] realized . . . he needed to always ignore the "mad crowd" and its inclinations.*

In adversity, Rockefeller had the ability to see the opportunity and most importantly possessed the courage to do what others were either unable or unwilling to do in order to profit.

While remaining rational, and even philosophical, is often challenging in the face of significant capital losses, I maintain it is certainly better than the alternatives.

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WHITMORE CAPITAL MANAGEMENT

About Whitmore Capital Management, LLC

Whitmore Capital Management, LLC was formed in 2012 to offer investors access to a proprietary foreign exchange investing program (the Fund, Whitmore Capital LP). This program focuses on cash currencies but may also include futures, forwards and currency options. The objective of the Fund is to achieve long-term returns superior to the Credit Suisse Hedge Fund Index.

At the very core of the investing program is a mathematical model developed by Mark Whitmore. This proprietary calculus for determining the "fair value" of exchange rates aims to identify long-term opportunities to profit from temporary currency market mispricing. The outcome of these quantitative analyses are supplemented by qualitative analyses of the circumstances surrounding each currency to determine the configuration of the portfolio itself. Finally, sentiment indicators are reviewed as an additional analytical overlay. Currencies traded for the Partnership's account may include, but are not limited to, pairs of the following currencies: AUD, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RUB, SEK, SGD, TRY, USD, ZAR.

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