Illusion of success: Why copying successful investors is a risky bet

Devina Mehra
feedback@livemint.com

There is a really fascinating story from World War II, when the US military was examining its bomber aircraft to see where to reinforce them. The aircraft returning to the base were examined to see which parts had taken the maximum hits, and plans were afoot to reinforce these parts.

That was when mathematician and statistician Abraham Wald pointed out that this analysis could be totally off, because it did not take into account the aircraft that did not return to base.

The parts which showed no hits were probably the parts where, if the aircraft took a hit, it would not survive and be able to return to base. The bullet holes in the returning aircraft, contrary to conventional thinking, represented areas where the bomber could take damage and still fly well enough to return safely to the military base.

So Wald proposed that the navy reinforce the areas where the returning aircraft were unscathed, inferring that planes hit in those areas were lost. It was a brilliant piece of analysis that totally inverted the conventional way of looking at a problem. ...

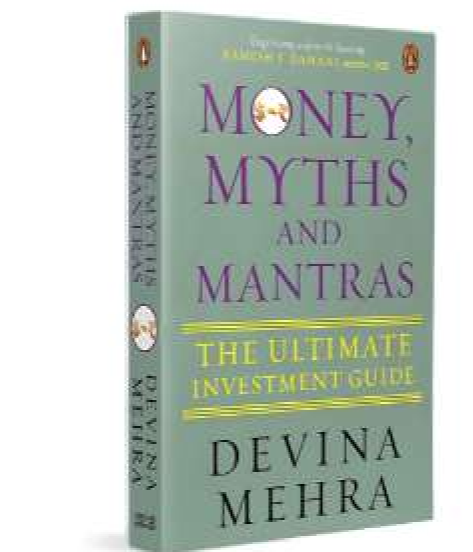
You must be wondering what this story has to do with following successful investors? Your starting point is investors who are/appear successful today. Then you look backwards at the strategies they have employed in the past. You are starting with success stories of, say, billionaire stock investors and attempting to reverse-engineer a personal pathway to similar success. The stated or unstated presumption is that if you follow their strategies, you will see similar levels of success.

Now, suppose some of these entities/investors had opted for extremely high-risk strategies, where most of those using these strategies went out of business. However, the few that were left standing became successful or rich beyond their wildest dreams. But your analysis does not take into account the entities that followed the very same strategy but failed or even went out of business. Or, in short, your analysis suffers from survivorship bias.

You think you are answering the question as to which strategies lead to success, but your actual analysis is inverted in order. Instead of starting with what happens to investors or fund managers who follow a particular strategy, you are instead looking at the strategies followed by the successful entities.

The two are entirely different inquiries to make. It is the equivalent of saying that if you want to become as successful as Bill Gates, you should drop out of college.

An example will make it clearer. Suppose there is a way of investing which is extremely high risk but can give high returns. Every year, 90 per cent of the people opting for it will go bust, but the balance 10 per cent will make ten times their money. Suppose 100,000 people start playing this game. Five years later, there will be only one person left out of these, but this person would have made $1,000 into $100 million. She will be the most successful investor in the market. Now, when you are evaluating options and know of this person who has converted $1,000 into $100 million, you will naturally want to emulate her methods, except that because of survivorship bias, you will not realize that 99.999 per cent of the people opting for this method or system will go bust.



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Think about this very deeply when you hear that all the richest investors in the world are optimistic, or risk takers, or whatever other defining characteristic of a rich investor is supposed to be. Outliers often take extraordinary risks to produce those magnificent returns. But just because a particular strategy worked one time for one person doesn't mean it's a good strategy to follow.

It's extremely unlikely that someone who has an investment strategy that generates significantly higher returns than the market has found a strategy that is safe and consistent. It is more than likely that he or she has simply 'survived', a very dangerous approach to investing. In short, he or she got lucky. It is like meeting a centenarian who has been drinking and smoking and eating lavishly all her life and assuming that following a similar lifestyle will get you to live to 100. It is not going to happen.

That particular person may have been extraordinarily lucky, in terms of her genes or some other factor, and is actually the exception that proves the rule. Even when the odds are not as extreme as in the example above, there is a general rule that holds. If you look at only the picture of who has made the most returns, we would say that being extremely aggressive is good.

In reality, maybe 90 per cent or 95 per cent of those who had these aggressive positions lost all their capital. And there are maybe 5 per cent who made outsized returns. In short, for any evaluation, start with all entities that followed that strategy and understand their trajectory rather than look at only the successful ones.

While the formula for success in investing appears simple—do what successful investors do—there is a whole host of fallacies in this path. First, the type of stocks they are said to hold may be very different from what they actually hold. Warren Buffett has NOT made most of his money in steady consumer businesses. Is their holding period what you think it is? Buffett, for instance, doesn't hold 80 per cent of his stocks for even one year. Even for systems that are not as high risk as this one, due to the sheer chance there will be some people who will make extraordinary amounts of money. But that does not mean the system that they followed was the best system to follow or will give the best risk-return trade-off. Have you even checked if these investors are 'successful'? Neither Buffett nor Ray Dalio has beaten benchmarks for over two decades.

Success is often a product of how markets have done over a period of time. Both in India and the US, market returns have varied by three to four times even over a decade.... Instead of following the path of the grand successes, you should ask what happened to all the entities who followed the same strategy. A high-risk strategy can have very few winners, but the ones that survive can have spectacular results. That doesn't mean it is the right strategy to follow.

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