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# Diversification

## The power of winning by not losing

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The image is indelibly etched in the mind of baseball fans everywhere. In 1988, an injury-hobbled Kirk Gibson, sick with a stomach virus to boot, limp-running around second base and pumping his fist. Without a doubt, Gibby's homerun is one of the most memorable in baseball history, setting up the Dodgers for an improbable Game One "W" and eventual World Series win. But in remembering the heroics of the moment, we tend to forget all that came before.

The score at the time of Gibson's unexpected plate appearance was 4 to 3 in favor of the Oakland Athletics, whose mulleted (and we now know, steroid-fueled) superstar Jose Canseco had hit a grand slam in the first inning. Canseco had an outstanding year in 1988, hitting .307 with 42 homeruns, 124 RBIs and, eye-popping by today's standards, 40 stolen bases. Loading the bases in front of Canseco was massively risky as was throwing him the hanging slider that he eventually parked over the center field fence. But riskier still was sending Gibson to bat sick with the flu and hobbled by injuries sustained in the NLCS. That we don't perceive it as risky is an example of what psychologists call "counterfactual thinking." It turned out in the Dodgers favor, so Tommy Lasorda is viewed as a strategic genius. But had it not, and simple statistics tell us that getting a hit is never in even the best hitter's favor, Lasorda would have been a goat.

Just as we laud improbable and memorable athletic achievements without adequately accounting for risk and counterfactuals, we do likewise with large and singular financial events. Paulson's shorting of subprime mortgage products. Soros shorting $10 billion in currency. These events are so large, so memorable and worked out so favorably that we ascribe to them a level of prescience that may not actually correspond with the expected level of risk-adjusted return. A friend of mine once joked that, "every man thinks he is ten sit-ups away from being Brad Pitt." Having observed

Image source: https://8583b52b4a309671f69d-b436b898353c7dc300b5887446a26466.ssl.cf1.rackcdn.com/12350969_a-good-omen-the-dodgers-start-the-nlcs_tcbdf1e5e.jpg significant overconfidence among both professionals and novice traders alike, I might similarly assert that "every stock market enthusiast thinks that (s) he is one trade away from being George Soros." The good fun we can have talking about, "The Greatest Trade of All Time" notwithstanding, most real wealth is accumulated by not losing rather than winning in spectacular fashion.

The danger in taking excessively risky bets with the hope of a spectacular win is best illustrated by what is formally known as variance drain. Variance drain is the difference between mean return and compound return over a period of time due to the variability of periodic returns. The greater the variability from peak to trough, the more the expected returns will deviate negatively. Confused?

Say you invest $100,000 each in two products that both average ten percent returns per year, one with great volatility and the other with managed volatility. The managed volatility money rises 10% for each of two years, yielding a final result of $121,000. The more volatile investment returns -20% in year one and a whopping 40% in year two, also resulting in a similar 10% average yearly gain. The good news is that you can brag to your golf buddies about having achieved a 40% return – you are the Kirk Gibson of the market! The bad news, however, is that your investment will sit at a mere $112,000, fully $9,000 less than your investment in the less volatile investment since your gains compounded off lower lows.

A second, behavioral implication of volatile holdings is that the ride is harder to bear for loss-averse investors (hint: that means you and everyone you know). As volatility increases, so too does the chance of a paper loss which is likely to decrease holding periods and increase trading behavior, both of which are correlated with decreased returns. Baseball fans know the frustration of watching their favorite player "swing for the fences", trying to end the game with a single stroke of the bat, when a single would do. Warren Buffett's first rule of investing is to never lose money. His second rule? Never forget the first rule. The Oracle of Omaha understands both the financial and behavioral ruin that come from taking oversized risk, and more importantly, the power of winning by not losing.

THE CENTER FOR OUTCOMES

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