The Myth of the Casually Competent Investor

By Steven Grey
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"The greatest trick the Devil ever pulled was convincing the world he didn't exist."
Verbal Kint, *The Usual Suspects*

Under certain circumstances, a myth becomes so embedded in the popular mindset that it transcends the illusion of truth and assumes the gravity of gospel. The capital markets at the heart of the American economy rely on just such a fallacy: The Myth of the Casually Competent Investor.

In most serious undertakings, the barriers to entry rise and fall with the complexity of the task. No one becomes an airline pilot merely by pinning a pair of plastic wings to his lapel. Nor is anyone permitted to perform an appendectomy simply because she had decided that morning that she was qualified to do so. And yet every day apparently intelligent people essentially declare themselves competent investors, as if the act of deciding somehow makes it true.

This pretense is facilitated in large part by an absence of impediments; we should all be thankful that it's considerably harder to gain entry to an operating room or the cockpit of a 757 than it is to open a stock trading account. But accessibility alone does little to explain the eerie confidence with which so many people willingly attack their own net worth – especially when most already know that the vast majority of professional investors fail in the long run.[1] Something is *compelling* these people to translate (1) almost certain odds of failure and (2) little experience, knowledge or training into… a high likelihood of success.

It would be convenient and even perhaps comforting to attribute this behavior to some perfect storm of human flaws. But even if we assume greed, arrogance, hope and/or stupidity in biblical proportions, it should take more to short-circuit our hard-wired instinct for financial self-preservation, shouldn't it? The fact of the matter is that investors don't recognize their own recklessness in part because they have been taught to perceive their weaknesses as strengths.

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[1] Long-run investment success (the only kind that matters) is defined as unlevered returns that exceed the S&P 500 Index over a multi-decade period by a margin sufficient to justify the additional risk assumed.

Investors have been conditioned to believe that ignorance is not only acceptable, but a kind of perverse virtue.

At every turn, investors are encouraged to believe not just that they can beat the professionals, but – astonishingly – that they can do so with a relative lack of effort. As one famously successful fund manager put it, "Any normal person using the customary three percent of their brain can pick stocks just as well, if not better, than the average Wall Street expert."[2]

It's doubtful that Peter Lynch, former manager of the Fidelity Magellan Fund and author of the above remark, is as casually dismissive of his own intelligence and hard work as his statement seems to imply. The quote is, to be fair, taken out of context, and Mr. Lynch certainly had nothing to gain by suggesting that potential clients bypass Fidelity and do their own investing. At issue is the integrity of the message, not the man, who was merely one of its numberless advocates.

The individual investor naturally gains some edge by not being encumbered with the conflicts typical of a large investment organization, such as internal politics, the negative influence of size on returns, etc. On this point Lynch & Co. are indisputably correct. But freedom from those burdens does not translate into investment success – any more than removing a backpack full of bricks would enable the average jogger to run a four-minute mile. However much its absence might ensure failure, common sense isn't the passport to investment success; it's simply one irreplaceable element.

Nothing is more dangerous to an investor than believing that one critical element of success suffices for all of them.

If any normal person could achieve outstanding investment returns using just 3% of their brain, there would be at least that many billionaire investors. There's a reason we don't see them – and it's not for lack of greed or horse sense. It's because no amount of common sense or intelligence can substitute for the analytic rigor necessary to consistently outperform. Smart investors have the humility to accept the limits of their own intelligence and the necessity of pure hard work. Reading the annual and quarterly filings, analyzing the financials and generating one's own projections, etc. takes days or weeks, not hours. Too many investors entertain a dangerously naïve disrespect for that basic research effort.

Some in fact insist, apparently seriously, that the high failure rate of the professional investor only proves that such efforts are futile. After all, if the pros do all that work and with few exceptions still fail, what's the point? Taken to its logical end this contorted

[2] *One Up On Wall Street*, Peter Lynch with John Rothchild, Penguin Books, 1989, pg. 13.

reasoning of course militates for never expending *any* effort on *anything*. Even a child understands that the way to outperform in most pursuits is to work harder and be more rigorous, not less. But more to the topic this excuse also relies on the false premise that the unsuccessful "professionals" failed despite doing the work when in reality most fail because they do not.

By refusing to acknowledge and perform the work necessary to succeed, investors are *choosing* to fail.

It's bizarre. In any other context, no one would dare suggest that a new subject is best mastered by *not* studying it directly. And yet many investors not only insist upon reading brokerage analyst reports in lieu of the easily-available primary information – the company's SEC filings. They contend that a secondhand, conflicted, abbreviated version is actually *preferable* to the original.

No doubt, perusing these pretty, pablumized summaries requires less mental effort than studying a pile of annual reports and proxies. Broker's reports are comic books compared to quarterly financials. But like reading a critic's review rather than the novel itself, they at best only enable one to feign comprehension. Apply the slightest pressure, and the veneer gives way. The sheer transparency of this charade would be laughable if it weren't so frankly embarrassing, especially given how selectively investors concede their ignorance.

Consider the following scenario: In an alternative, parallel world, an investor is handed a *GoldMorgan Lynch* five-page report trumpeting the investment virtues of Raphaelite art, noting that the price appreciation of works by the Old Masters has historically kept pace with the S&P 500 over the long term (which is for the most part accurate). Most investors wouldn't even give it a second look because their ignorance of the subject matter is so glaring that they would be embarrassed to deny it. Of course, it helps that no one is encouraging them to pretend otherwise. CNBC isn't (yet) blasting commercials announcing that "You too can beat the pros at investing… *in Masters of the Italian Renaissance!*"

And yet, somehow, that same individual will read a couple of Wall Street brokerage reports on a company that produces high-tech ceramic casings for mounting gallium arsenide computer processing chips, look at a price chart or two, and conclude "I now possess sufficient expertise regarding this company, its industry, and its future prospects to put my money at risk." They in fact possess nothing of the sort, but rather just enough knowledge to seem like they know what they're talking about to someone who doesn't.

The standard justification for this deliberately shallow grasp is that the alternative – a truly in-depth understanding – is impractical. But the question of what is practical is a straw man, because the time one makes available for a task has no bearing on the time objectively required to do it well. Only the willfully careless prefer excuses to information. –

The intelligent investor genuinely strives to make it as difficult as humanly possible to make the wrong investment decisions.

The investment industry is littered with intelligent failures because too many participants refuse to accept that intellect is not a substitute for information. If one investment frequently has almost nothing to do with the next, how could it be otherwise? While both a shipbuilder and a business software company might be equally profitable, the underlying businesses share almost nothing in common. What makes either an attractive investment is a direct function of the details specific to each, not the background or brainpower – however helpful – of the analyst.

Some facts are always more relevant than others, of course. But insight is distilled from information. In the same sense that even a genius cannot identify the key points of a book he's never read, an investor is very unlikely to identify what drives an investment outcome if he ignores most of the information pertaining to it. Certain problems may be obvious, but the fact that some are difficult to overlook does not mean that all of them are. Few habits in investing are as dangerous as dismissing what is unknown as unimportant. Regardless of who is willing to admit it, while reading the footnotes to the financials is rarely riveting, it is seldom a waste of time, and more than occasionally reveals something critical. Intelligence, as well as the intuition that derives from years of hard work, undoubtedly contribute to the analytic process. But every investment outcome nonetheless remains hostage to the information that drives it.

It's the investor's choice. The question has never been whether a determined individual of average intelligence could succeed as an investor. The issue is whether he is willing to acknowledge and perform the onerous amount of analysis required to have at least a decent chance at consistent success. The issue, in short, is intellectual honesty.

In the end, most investors are victims not because they're incapable of doing the requisite work, but because they refuse to admit that they're unwilling, yet insist on investing anyway.

As with most things, self-deception proves easier than self-discipline. On the laundry list of convenient excuses for poor returns – the market did *this*, how could I have known *that* – willful ignorance is distinguished by its absence. Perhaps, in the end, the greatest trick Wall Street ever played wasn't theirs at all, but the one too many investors willingly played on themselves. And, by all indications, continue to.

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