Asset Management

News or Noise: What Baseball Can Teach Investors

By David Fisher, Chief Investment Officer

Baseball and investing have always had close parallels. No other sport focuses as much on data and analytics as baseball. Further, with a regular season that runs 162 games, plus up to 20 additional games in the playoffs, it is truly a sport of stamina for the team that ultimately wins the World Series.

Many lifetime investors, including myself, got started studying the box scores for their favorite team in the newspaper or spending hours reviewing individual performances on the back of ball cards. That connection isn't surprising, given that investors can learn a lot from studying what works in baseball and applying that to investing. With the "Boys of October" wrapping up the season this week, it seems appropriate to look at three lessons baseball can teach us about investing.

No Called Strikes

Baseball is famous for being a sport where doing something right one-third of the time is deemed a success. Professional players who hit .333 are considered the elite of the sport. But investing changes one dynamic—there is no umpire calling strikes if you don't try. What is the lesson here? Know the rules of the game you are playing.

Warren Buffett once said, "I call investing the greatest business in the world … because you never have to swing. You stand at the plate; the pitcher throws you General Motors at 47! U.S. Steel at 39! And nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it."[1] Why is this so important? Human beings are herders by nature. Investing brings out this instinct, along with many other psychological factors that ultimately hurt performance. In fact, the No.1 mistake investors make is to "trade far too much—and often at the worst times."[2]

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Every year, financial data firm Dalbar releases a study of the markets versus investor performance. Over the past 20 years, its research shows that investors captured only 5% of the 9.2% earned by the S&P 500.[3] It is true that in aggregate investors can't earn more than average, but 80% of all investors fail to even match that level, which does leave excess returns for some investors to capture. Remember, by the time you hear all your friends and colleagues talking about an idea, it is probably too late to invest. Investors should more regularly take a lesson from Buffett and put their bats on their shoulders.

Consistency over the Season

As mentioned in the introduction, the baseball season is the longest of any major U.S. sport. That means streaks—both winning and losing—have a disproportionate impact on the season. Moreover, it is not possible to get through a full season without having a streak of bad performance. What separates the winners from the losers? Two things, in our opinion: one, keeping bad streaks to a minimum and, two, staying calm but focusing on details during a downturn.

We researched the success rates over each 10-game stretch for the 20 teams that won their league pennants between 2004 and 2013. On average, the teams that made it to the World Series had a winning record over rolling 10-game stretches 79% of the time. It is also noteworthy that not a single one of those 20 teams was "perfect," meaning they all had at least one 10-game stretch where they had five or fewer wins. The best team was the 2004 Cardinals, which achieved 97%, while the 2006 Cardinals actually had losing streaks nearly one-third of the year.

The reality is that each day when showing up to the field, a baseball team truly believes they can meet the objective: to win that game. However, they also realize that there is no way they will actually win every game. Rather, the real goal is to manage the losses and still make it to the World Series. When teams enter a downturn, each one questions everything they do. But confident coaching staffs won't fire every player on the team and start over. They recognize that streaks happen and the key is to play through the downturn, focus on fundamentals of the game and make a few tactical adjustments. Investing is the same. Investors who react to a bad streak with emotion will more often than not make poor long-term decisions. The key is to maintain discipline in your process, seek constant improvement and keep your eye on the long-term goal.

Be a Value Investor

In 2004, Michael Lewis wrote a book about baseball called *Moneyball*, and it rapidly became a best-seller among an unusual crowd—value investors. Why did these individuals gravitate to the story of Oakland A's general manager Billy Beane and his attempts to take a low-budget team to the playoffs? By focusing on statistics that were underappreciated and undervalued in the traditional talent scouting circles, Beane was able to assemble a low-cost team that consistently won games. Though a Beane-managed team has yet to win a World Series, he has had multiple trips to the American League Championships and has consistently had playoff-contending teams while staffing those teams with payrolls that often fall in the bottom 20% of all clubs.

There are two specific lessons we can learn from Beane. The first is to focus on lesser-known statistics. The second is to stay away from the superstar players. On the first point, Beane focused extensively on on-base percentage rather than batting average or home runs. His rationale was based on the fact that the industry traditionally paid a lot for high batting averages, but getting on base was all that really mattered. Whether a player gets on via walks, hit-by-pitch or hits, he is equally as valuable, and Beane didn't have to pay as much for players with lower batting averages. Second, Beane's teams were highly focused on clubhouse culture and teamwork rather than the individualism that many teams with superstar talent seem to experience.

For many years, the established baseball community ridiculed Beane's philosophy, but over time his winning percentage got people's attention. Many of these lessons also apply to investing. As Howard Marks, a great investor and founder of Oaktree Capital Management, once said, "Unconventional behavior is the only road to superior investment results, but it isn't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes."[4]

One Day at a Time

The World Series will wrap up this week and a new champion will be crowned. It is critical to recall that 30 teams started the season with the hopes of making it to the Series. The two that made it this far had a clear understanding of their long-term goals. They focused on unconventional playing and management styles and for the most part are not flashy teams. They, like investors, took one day at a time and didn't get emotional when the difficult times came. Baseball is clearly a game, and investing is about clients' livelihoods and personal goals, but there are still many lessons we can learn about investing from baseball.

Sources

1. http://en.wikiquote.org/wiki/Warren_Buffett
2. Dzombak, Dan. "The No. 1 Mistake Investors Make." The Motley Fool. October 24, 2014.
3. Ibid.
4. Marks, Howard. "Dare to Be Great II." Oaktree Capital Management. http://www.oaktreecapital.com/Memos/Dare%20to%20Be%20Great%20II.htm.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.